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Creating Economic Space for Social Innovation

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Theoretical Foundations of Social Innovation in Finance

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Theoretical Foundations of Social Innovation in Finance

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1. Introduction

Christopher Houghton Budd and C.W.M. (Ro) Naastepad
(Delft University of Technology)

The four papers that comprise this deliverable were submitted blind to each other. The sequence we have placed them in is intended to reveal the 'story' they seem to tell when read together. To this end they are arranged in two pairs, in each case a longer paper followed by a shorter one.

We begin with the paper from Heidelberg University, which describes two cases one hundred years apart, where the focus is on investing in ways that provide (or otherwise) 'social' housing and the claim that this form of investing – "5% philanthropy" – has beneficial consequences for 'the marginalised'. However, the current orientation of investors may lead to the most marginalised not being targeted and reached while the question what social value is and how it can be measured also remains a moot point.

The paper from the Austrian Institute of Technology is in effect a further study of social housing as people have sought to understand it and give it effect in Austria since WW2 in particular. Tellingly, the paper concludes that such housing is more and more difficult to provide because the country conforms to the European Union's competition policies, making the conduct of its economy dependent on the logic of 'the market', and of financial markets in particular.

Behind both these papers lies the idea that the providers of capital decide the terms of its use. But maybe this is the problem. By way of illustration of this point, the second pair envisages a world in which capital is used in accordance with the possibilities and circumstances of those who use it.

It is in this sense that the first paper of the second pair, from Delft University of Technology, looks at the practice and study of economic life through the lens of accounting – a technique that is neutral to the way we use capital and so serves as a medium for effecting a transition. Relaxing the assumption of the 'piper calling the tune' takes one out into a landscape of very different perceptions and expectations, suggesting that our problems have more to do with how we understand such things than how they are structured.

The paper from the Institute of Economics of the Centre for Economic and Regional Studies, Hungarian Academy of Sciences, is in this mould. Focusing on the case of Roma people, it identifies as their main problem, at least from a 'bottom-up' perspective, that we need to ask what hinders their development in *their* terms, not ours. Very soon the answer seems to be lack of access to credit on terms that enable them to fulfil what they know they can achieve were it not for the difficulty in getting appropriate amounts and types of capital.

Finally, the authors were encouraged to link their work to the Extended Social Grid, which combines the perspectives of Sen, Beckert and Mann. This they did in various ways, ranging from structured to discursive, formal to light, extensively to not at all, allowing readers to judge for themselves whether the extended social grid 'works' as a whole, or only partially. Or whether, of the three perspectives, any one is more useful than the other. The Heidelberg paper, for example, uses Beckert's three 'fields' (social networks, institutions, and cognitive frames) as a framework of analysis, while also referring to Mann's 'sources of social power'. The Delft paper, on the other hand, suggests that we are faced mainly with cognitive frame issues, which need to be addressed before the social network and institutional dimensions can be resolved.

1.1. Outline of papers

The paper *Five per cent philanthropy as an early form of social impact investing – differences, parallels, and what can be learned for today* by Thomas Scheuerle and Gunnar Glänzel explores whether and in what ways capital markets can create "social value", or "social good". The paper compares contemporary 'social impact investing' (SII) with the 'five-per cent philanthropy' (FPP) that was practiced in Victorian London in the middle to late 19th century as a way of providing what today is called 'social housing'. The aim of SII, according to its proponents, is to address the social needs of marginalised populations by providing capital (e.g. equity or debt) at a lower financial compensation. With the rise of these new 'investment objects', the "boundaries between what is seen as financial market instruments and funding sources in the social sector" have become increasingly blurred.

The paper uses a mix of theoretical frameworks – Jens Beckert's three 'social forces', Michael Mann's 'sources of social power', Amartya Sen's Capability Approach, and the 'multi-level perspective' (MLP) on innovation − to compare the impact of FPP and SII on housing and marginalisation. It describes how 'five-per cent philanthropy' arose in the context of the transition from an agricultural and rural society to an urban and industrial society which had led to a rising class of "bourgeois capitalists" with free-market values and "unhampered exploitation by many landlords". Expressed in Beckertian terms, the authors argue that 'five-per cent philanthropy' was born of (a) a *cognitive frame* that was shaped by the 'bad conscience' of businessmen who had become rich in the free-market economy of the time and that permitted philanthropy but not public intervention; (b) easy access by promoters of FPP to powerful *social networks* at the 'regime level' which helped to, for example, acquire land property at very low prices; and (c) virtually non-existing *institutions*; "rent controls, construction standard laws, or enforceable hygiene standards were hardly existing, relatively weak, or even counterproductive". The authors conclude that although FPP has been successful in terms of building houses and housing people, it housed only relatively better-off workers, not the "lowest class", and its success lagged "far behind the size of the problem".

In comparison to the relatively small scale of FPP in 19th century London, SII today is a "global phenomenon" availing itself of a "more developed *cognitive frame*" that supports business-driven methods for promoting social purposes (or "philanthrocapitalism"); supporting *institutions* such as governments that no longer have the political or financial support or even will to fund social purposes, and financial institutions seeking for new and safe objects of investment for their clients; and *social networks* created around the intersection of two developments: the already mentioned rise of "venture philanthropy", and the rise of shareholder capitalism since the 1980s.

The idea (or *cognitive frame*) is twofold; first, SII is needed to fill the finance gap between, on the one hand, the sizeable funds required for "social purposes" (including health care and education) and on the other, the funds coming from both public financial support and private funding (donations, grants); second, "social problems … could be addressed by (social) entrepreneurial means more efficiently and effectively than in the status quo of established welfare systems." The *social networks* promoting SII "are comparably small", but "the actors are part of or have access to elite power networks in the economic and political domain". An example is the *Global Impact Investing Network* (GIIN), founded in 2009 on the initiative of the Rockefeller Foundation. The financial construct depends critically on "the idea of leveraging public money" in addition to the private capital that is attracted. There are also signs of proceeding *institutionalisation* in the field, including the growth of intermediaries and associations, market places, consulting, the provision of data, and "ethical banks".

Some issues or "barriers" still remain, however, including impact measurement ("the question of how social value is measured and valued in financial terms") and, in the case of FPP, "the strict business case orientation" that has "led to the most marginalised not being targeted and reached." The latter is explained by the fact that "social impact in the form of enhanced capabilities of the marginalised had not been part of the cognitive frame on which the approach was built." "Consequently," the authors conclude, "probably the most important learning is that the approach failed to improve the capabilities of the marginalised but also never set out to do so, as the cognitive frames at work within the networks of FPP actors were rather shaped by business logics and market liberalism." According to the authors, modern SII puts more emphasis on social impact and its measurement; "thus, the preconditions to achieve at least some form of social impact are much better, because social impact is a decisive constituent of the cognitive frame on which SII is based." However, to what extent SII actually reaches the marginalised and improves their capabilities, and who determines what kind of capabilities are improved, is a question that is not answered in this paper and so remains a moot point.

In *Financing of social housing*, Susanne Giesecke describes municipal, non-profit housing in Austria and how E.U. competition law, as well as free-market advocacy in the housing sector, have caused some discontent among housing policy makers due to attempts to restrict national sovereignty in the field. Article 107 of the *Treaty on the Functioning of the European Union* (TFEU) requests that "any aid granted by a Member State or through State resources in whatever form whatsoever which distorts or threatens to distort competition by

favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market." This article challenges the non-profit status of social housing projects on the grounds that rents are decreased artificially by this practice, thus infringing European Union competition law. Overall, the policy of leading E.U. authorities and O.E.C.D. experts is "to reduce social housing in general and promote an unregulated free housing market." Not surprisingly, therefore, critiques of "the transgression of competences of the E.U. authorities and the breach of the subsidiarity principle" by Article 107 have until now remained without effect.

The paper identifies some issues in housing policy, such as the discussion on dualist versus integrated (or unitary) rented housing, and the question whether the state should intervene on the supply side (still the dominant approach of Austria's housing policy) or on the demand side of the housing market. The neo-liberal turn in general has led to more reliance on private asset building and compensation to poor households through income-related subsidies; thus, support for housing becomes effectively a subsidy for private asset owners. The most vulnerable households often reside in the private rented sector without income support because they are not entitled to social support. The stock of social housing is still a significant share of the overall housing stock in E.U. member states such as Austria, France, Denmark, Sweden and the Netherlands, but in the E.U. in general it is declining while the demand for social housing is increasing. Alarming also is the decrease in new social housing dwellings in most E.U. countries, including the U.K., the Netherlands, Austria, Italy, Denmark, Ireland, and Spain.

Social housing policies can alleviate the worst income effects of macroeconomic events such as the real estate bubble, the financial crisis, and the credit crunch. They could also play a role in bringing about a mix of inhabitants (preventing urban segregation) and social stability, and in preventing real estate bubbles. Undeterred and unrepentant, the paper's author argues that, "social housing is … an instrument for compensating market failure, because in the long run a free market cannot provide affordable housing for the low and middle income households"; therefore "the state has to take major responsibility for public provision."

However, at the end of the paper, a third possibility is mentioned that could ease, if not render obsolete, the market-state dichotomy: community-oriented, non-profit social housing as a "third sector" between the state and the market. The example given is Germany's *Mietshäuser Syndikat* – a construct that aims to take houses out of the market and render their use, as also their internal allocation, a matter of direct decision-making processes on the part of those affected. At a time of rising need for social housing but falling provision, this approach is catching on, but whether it can crowd out, let alone turn the tide on, neo-liberal policies remains to be seen.

In *Twin value theory as reflected in accounting, and its consequences for our understanding of capital*, Christopher Houghton Budd describes how economic value arises from two sources: the expenditure of labour on nature, transforming it in some way, and "wits, intelligence, ingenuity, 'nous' ", or human *capacities* that save or obviate labour by

organising it in intelligent ways. In the process, a financial surplus or "excess capital"[1] arises that accumulates on balance sheets and raises the question: What is the counterpart of this capital?

His answer is capacities, which can only grow and unfold when they are funded or "capitalised". Unless excess capital is used to "capitalise capacities", individuals will remain without opportunities for self-determination, self-empowerment and autonomy. Per Sen's vocabulary, capitalisation is the main factor in the conversion of "capabilities" into "functionings" (things one value doing or being). Those who cannot get access to such funding can be said to be "credit-marginalised", constrained in the development and use of their capacities by lack of access to funding. The key to addressing "credit marginalisation" is "open-access credit" (OAC), the funding of people who have the capacities but not the capital to carry out their initiatives on terms determined by the circumstances of the receivers, not the providers of credit. This is the social innovation in finance discussed in this paper. Open access credit is conceived as "a way of making good excess capital by using it to foster, unfold and facilitate the expression of human capacities and initiatives".

A main part and the practical argument of the paper is devoted to explaining how *twin value theory*, hinted at in a seminal quote from Adam Smith, is reflected in accounting. Seminally, for example, the accounts of self-employed people show that they do not receive their income as a 'wage', but as 'drawings', a reduction of 'own capital', which is their part of the value (understood in accounting terms) that arises in a business as the joint result of the entrepreneur and all stakeholders, not the entrepreneur in isolation. This process is mirrored in the structure of accounting, which expects income to exceed expenses, with the difference or profit best understood as a measure of "the social validity of an enterprise as also that of its entrepreneur's contribution to society".

The question then arises: To whom does profit belong? In "standard economic theory, as also in the capital structure of conventional corporations, profit is assumed to belong to the external providers of capital, the shareholders… Accounting, however, implies no such social contract." If one regards "the true nature of economic activity as other- not self-serving", the possibility opens up of a second role for capital besides financing the physical means of production, namely to finance the development (education) and application of capacities. Wide-ranging and far-reaching or even 'politically impossible' though this idea may be, it is nonetheless conceivable. Its logic is that of teaching someone to fish. If people can be capitalised for what they want to do in life, they will be able to take responsibility for and so drive their own lives (and economies), because they can give expression to looking to their own inherent wealth, rather than looking to the wealth of others directly or via subsidies from the state.

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[1] The notion of excess includes the assumption that "the sales of an enterprise have been freely made by its customers, and […] none of the expenses have been at the cost of the enterprise's environment, neither physical (e.g. nature) nor social (e.g. remuneration)".

In *The problem of social collateral in micro-lending*, György Molnár explains how, in micro-credit (*e.g.* the Grameen Bank model), the practice of taking collateral that is at the core of lending by banks is transferred to the social sector, with peer pressure performing the role of coercion that otherwise the bank would play. From both a theoretical and practical point of view, the author concludes that using social collateral "contradicts the principle of free and sustainable agency". It "promotes segregation and internal conflicts" and reduces trust and community, "taking away the possibility of collective action". Thus using social collateral contradicts the aim of empowerment of marginalised people. Instead of coercion, Molnár pleads for a careful selection of clients, which can only be the result of a carefully built process of several years' duration which, however, has additional costs. The selection would differentiate between clients who failed in their business and those who intentionally did not pay back their loans. Importantly, "failure should not be punished", but followed up by "further learning and practice". At the same time, the effects of the exclusion of non-cooperative clients serve as an important learning experience to the others in the given settlement as well as to potential clients. Although this method would increase the costs of the programme, it would provide better results in terms of poverty alleviation.

In other words, one cannot have one's cake and eat it. Something, or someone, has to give, some capital has to be given up or at least 'committed' (not made subject to a return) if the element that makes rents unaffordable – capital locked into real estate rather than linked to the capacities of individuals – is to be overcome.

1.2. Conclusion

On balance, and from a future policy perspective, taken as a whole these papers show that the more the prevailing paradigm is a neo-liberal one, the more, that is, that 'free' markets are deemed to be appropriate and adequate allocators of both private and public goods, the less is the scope of the state with regard to social provision. It not only has a diminishing resource base relative to the problems it is charged with addressing, but it finds itself in that situation because the validity of its social role is being questioned. In its stead 'hybrid' (private-public) constructs are thought to provide an alternative. But did they then (19th century) and do they now (20th century) deliver on this promise? Conversely, had capital not become wedded to real estate (had it been linked to capacities rather than 'land'), would it *then* have become and could it *now* become the medium for creating economic space for social innovation, with social innovation understood to include the many projects that people seek to realise today, but for which they lack appropriate types and amounts of capital. Projects would then be able to be value-creating in their own right, rather than dependent on grants (i.e. the redistribution of value created by others).

To think in this way is to qualify and indeed question the meaning of 'the marginalised' inasmuch as their problems are thought to stem from lack of income, poverty, and so on. The same people, were they able to have their capacities capitalised might find themselves in a very different landscape, one that empowers rather than inhibits them.

2. Five Per Cent Philanthropy as an Early Form of Social Impact Investing – Differences, Parallels, and What can be Learned for Today

Thomas Scheuerle and *Gunnar Glänzel*
(University of Heidelberg)

Abstract

The paper deals with financing social innovation today and during the Victorian age. It explores ways in which capital markets can create value beyond private profit today and how private actors did the same thing back then. The ways to do this are nowadays often subsumed under the heading of *social impact investing* and one of the historical paths was called *five percent philanthropy*. When successful, both approaches create financial as well as social, yet there are substantial differences. We look at both concepts and how they are/were practiced, practitioners' motivations, contexts/ecosystems, driving forces, investment fields, financial performance and their impact on beneficiaries' capabilities. We do so by applying two theoretical lenses: The *extended social grid model* and the *multi-level perspective*. We found that the Victorian approach did not target the most marginalized, and so did not enhance their capabilities significantly and therefore would not completely qualify as an early form of financing social innovation; but it did fare quite well economically. In contrast, social impact investing today has the potential to make a difference for the most marginalized, however it needs to be seen whether or not it can leave its niche status behind and gather momentum, and that in turn depends on whether practitioners succeed in finding enough economically successful investment opportunities. However, the historical case provides some evidence for the claim that in order to make a difference with severe social problems, a finance first investment approach may not be sufficient.

2.1. Introduction

2.1.1. Practical problem

Along with the rising discussion of social innovation, the discussion on financing such endeavors has also increased, both as a supportive activity (Glänzel *et al.*, 2013) as well as a social innovation itself (Nicholls, 2010) Among the core topics here are instruments that blur the boundaries between what are seen as financial market instruments and funding sources in the social sector, such as philanthropic grants and state spending (Bugg-Levine and Emerson, 2011; Grabenwarter and Liechtenstein Heinrich, 2011; Hebb, 2013). The latter are often perceived as being too restrictive for increasingly entrepreneurial and income-based social innovation approaches (e.g. Priller *et al.*, 2012; Thompson and Williams, 2014), since they are often quantitatively limited, tied to specific projects, or may not allow investments in overheads or R&D or innovation (Brown, 2006). Thus, this paper explores in what ways capital markets can create value beyond private profit.

One of these ways is social impact investing (SII), which draws on financial instruments from venture capital (VC) such as private equity, debt, or hybrids of these (convertible debt, mezzanine capital, etc.) (Martin, 2013), but incorporates the idea that investors do not exclusively target *financial* returns. Instead they additionally focus on measurable social returns as well and accept lower or no financial compensation for their investments as a consequence (Hebb, 2013). SII markets and ecosystems have begun to develop in several countries, most notably in the UK and US, but also in Australia, Germany, India, China, France, Belgium, Canada, Brazil, and South Africa. The development was initiated by private, entrepreneurial and socially responsible individuals and organizations from the charitable sector as well as from the financial industry, but it has also been increasingly driven by a growing variety of political support measures, most recently the Social Impact Investment Taskforce convened under the UK's presidency of the G8 in 2013. Under this umbrella, National Advisory Boards with stakeholders from civil society, policy makers, and financial institutions were set up to discuss and develop measures to develop favorable ecosystems for SII that are well adjusted to the national preconditions (Social Impact Investment Taskforce, 2014).

Although SII is often framed as a highly innovative approach, the basic idea of addressing social needs of marginalized populations through financial means following a capitalist logic has been around for centuries. In particular, the approach of "five per cent philanthropy"[2] (FPP) that was practiced in Victorian London in the mid of the 19th century seems to have various parallels with what is discussed under the SII label today. In this approach, local proactive bourgeois personalities tried to prove that the housing misery caused by industrialization could be solved with market-based approaches if investors would be satisfied with a moderate return (below market rate) (Adam, 2002; Tarn, 1973). Since innovations are quite often reconfigurations of existing practices, this does not mean that SII today cannot be seen as an innovation itself (Nicholls, 2010), although it might only be an incremental improvement when taking a larger lens and looking at the general idea of financial investments in social and ecological goods.

2.1.2 Previous research

Previous research on this issue is rather limited, since research on SII or social finance in general is only in its beginnings (Daggers and Nicholls, 2016; Nicholls, 2010; Glänzel and Scheuerle, 2015). Very few authors take a historic perspective, and if so they do not decisively look at social finance and investment, but more generally on the cultural and social development of money and finance through the times (Ferguson, 2009; Jung, 2010; Sedlacek, 2011). Younger developments such as microfinance (Battilana and Dorado, 2010; Glänzel and Schmitz, 2016) (since the 1970's) or ethical/socially responsible investment (Dunfee, 2003; Johnsen, 2003) (SRI; since the 1990's) are not very much comparable with SII and research on them neither takes a historic perspective or makes comparisons.

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[2] The term has been coined in a 1887 pamphlet published by the National Dwellings Society and entitled "Homes of the London Working Classes: Philanthropy and Five Percent" Wohl (1977, p. 141)

2.1.3 Approach

In this paper, we make a closer comparison between SII in general today and FPP in the context of social housing to understand the differences and similarities and what might be learned from the historic example. For doing so, we apply the extended social grid model (Nicholls and Ziegler, 2014), which has been developed as a framework to understand change processes within social innovations. Building on three different strands of research, the model integrates cognitive frames, social networks and institutions as "irreducible social forces" to explain change in markets (Beckert, 2010) with a model from historic sociology that distinguishes different sources of societal power to understand influential factors beyond the economic domain (Mann, 2013; Heiskala, 2014b) and the capability approach according to Sen (2001) and Nussbaum (2006) to give conceptual underpinning to the 'social' part of social innovation.

2.1.4 Main findings

1. The strict business case orientation of the FPP approach led to the most marginalized not being targeted and reached. In general, the approach has more or less failed as an attempt to solve the social housing question it sought to address. It did succeed in a small niche though, but that was way too small in relation to the sheer size of the problem.

2. The FPP approach did not fail economically, however. Translated into modern SII terminology it was a "finance first"[3] form of impact investing which helped to make it an economic success but prevented it from alleviating the social problem it aimed to tackle.

3. SII in contrast may be more likely to make a difference, but has not left its niche yet. Nevertheless, supporting institutions and cognitive frames are nowadays more developed and may help SII to reach mainstream.

For SII actors and policy makers today, this means cognitive frames and institutions can be built on, but they also require attention and careful further development. And it also means that making a difference with severe social problems, a finance first approach may not be sufficient. As a result, various actors may have to cooperate and contribute resources to SII approaches that are not always entirely self-sufficient on their own.

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[3] A „finance first“ approach to SII places higher emphasis on financial returns compared to what is called an "impact first" approach in which social impact is valued relatively higher Hebb (2013); also see p. 7 below.

2.2. Conceptual foundation

2.2.1 The Extended Social Grid Model

Our conceptual foundation is the *extended social grid model* (ESGM) (Nicholls and Ziegler, 2014) which combines three theoretical strands in economic and historic sociology (for the following paragraphs cf. Nicholls and Ziegler 2014: pp. 2-4) linked through the constructs of *power* and *capabilities*. The first stream draws upon Jens Beckert's (2010) work on change in markets, in which he identifies three irreducible "social forces" which constitute a "social grid" influencing the resources and power positions of different actors (Beckert, 2010, p. 606): *social networks* comprise the structures of social relations and relational patterns in society; *cognitive frames* are commonly shared meanings and interpretive material by which to make sense of society and its actions; and *institutions* are the constraining rules and norms of a given society. The ESGM extends this approach, which is based on the theory of (institutional) *fields* (DiMaggio and Powell, 1991; Bourdieu, 2005; Fligstein, 2001, pp. 67–69), beyond the market domain, assuming that social issues such as marginalization are also caused by non-market factors.

For doing so, different societal sources are drawn from the concept of *power mechanisms within social change* (Mann, 2013) as the second theoretical strand. Power is understood here as the ability to pursue and attain goals through mastery of one's environment. Mann's sources of power (economic[4], ideology, military-related, and political) (Mann, 1986, p. 22) are extended to include *natural* (e.g. natural catastrophes, topographical or weather conditions) and *artefactual* power (science, tools, technologies, infrastructure etc.) (Heiskala, 2014a; Nicholls and Ziegler, 2014). It is important to note that power usually does not result from just one category, but there are "multiple overlapping and intersecting socio-spatial networks of power" exhibiting "functional promiscuity" (Mann, 1986, p. 17), such as the administration of a nation state which is not purely focused on politics, but also on other issues, such as economics or culture.

The third strand of the ESGM is the *Capabilities Approach* (CA) to human development and empowerment exploring the effects of (changes in) prevalent socio-economic structures on the opportunities to act of marginalized populations (Sen, 1999; Nussbaum, 2006). Within the ESGM, the CA serves for the evaluation of process and impact of the change in the socio-environmental context induced by the social innovations for the beneficiaries from the micro-level, not the least because the *capabilities* (individual and collective) constitute a form of power as well. They encompass the real opportunity to do (e.g. participate politically) and to be (e.g. being healthy) what one has reason to value. Even more, the approach allows one to think of the citizens not just as "patients" but also "agents", who co-shape innovation processes (Nicholls and Ziegler, 2014).

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[4] In this paper, economic power is broadly understood in terms of the transformation, distribution and consumption of the produce of nature, and exchange relations in markets are one especially dynamic part of this power, but they do no exhaust economic power Nicholls and Ziegler (2014, p. 5).

2.2.2 Multi-level perspective

The 'multi-level perspective' (MLP) on transition towards holistic sustainability understands transition as an 'outcome of alignments between developments at multiple levels' (Geels and Schot, 2007). It assumes that socio-technical transitions occur in the interaction between three analytical levels: *niches*, sociotechnical *regimes*[5] and sociotechnical *landscape*. The *niches* form the micro-level where novelties, ideas and innovations emerge. Geels and Schot describe niches as incubation rooms because they comprise unstable configurations and protect innovations against well-established market structures (2007, p. 400). The sociotechnical regimes form the meso-level, which refers to cognitive routines, belief systems, regulative rules and normative roles. Hence, the regimes are responsible for the stability of existing sociotechnical systems (Schot and Geels, 2008, p. 545). The macro-level or rather the environment beyond the niches and regimes is the sociotechnical landscape. An example of such a landscape are deep cultural patterns or macro-political developments (Geels and Schot, 2007, p. 400). Between these three analytical levels exist everlasting mutual interactions. For example, niche-innovation arises through learning processes while simultaneous change at the landscape-level provokes struggle and uncertainty within the regimes, e.g. in times of crisis. Consequently, the "destabilization of the regime creates windows of opportunity for niche-innovation" (ibid.).

Different kinds of transition pathways emerge through different kinds of multi-level interactions. Therefore, an extended MLP provides a typology of transition pathways which consider reproduction processes, transformation paths, de-alignment and re-alignment paths, technological substitutions and reconfiguration pathways (Geels and Schot, 2007, pp. 406–413):

- *Reproduction processes* of the regimes occur if there is no external pressure from the socio-technical landscape, and even fully developed niche-innovations might be unable to stand up to stable regimes.
- *Reconfiguration pathways* occur when regimes adopt niche innovations, although there is no external landscape pressure, but because they have a symbiotic relationship with the regimes or can resolve some problems. The base architecture of the regime is not changed rapidly, but might open opportunities for further adaptions and a slow-moving change.
- *Transformation paths* occur under moderate (perceived) landscape pressure yet without sufficiently developed niche innovations. In this case, new regimes emerge mainly through reorientation, potentially with an advising role of system outsiders. Sometimes some knowledge from niches is adopted, but rather in addition to and not to transform the regimes.

[5] The term regime was coined by Nelson and Winter (1982) in their classic innovation system work, referring to the technological domain only, however, by meaning shared cognitive routines among a wide community of technicians, e.g. engineers.

- *De-alignment and re-alignment paths* occur under divergent and sudden landscape pressure. If there are no fully developed niche-innovations as clear substitutes, huge insecurity in the regimes arise, and multiple poorly conceived niche-innovations co-exist until eventually one innovation gains momentum and becomes dominant as re-alignment and re-institutionalism of the sociotechnical regime.
- Finally, *technological substitution* occurs when landscape pressure on the regimes offers 'windows of opportunities' for sufficiently developed niche-innovations which are capable of replacing established regimes and to provoke knock-out effects, causing further possibilities for the implementation of niche-innovations.

In response to critique stating a *lack of agency* in the model (Smith *et al.*, 2005; Genus and Coles, 2008), Geels argues that the MLP acknowledges agency by considering trial and error, learning, searching, or interpretative activities of the niche and regime actors (Geels, 2011, pp. 29–30). Another criticism refers to the operation and specification of the regimes.
Further, Berkhout et al. (2004), (Genus and Coles, 2008; Markard and Truffer, 2008) point out the inaccuracy of the conceptual levels for empirical application. Geels counters with the argument that the sociotechnical levels could be defined on various empirical levels according to their scope. The MLP does not determine the narrow or extent for the operationalization because a regime should be an "interpretive analytical concept that invites the analyst to investigate what lies underneath the activities of actors who reproduce system elements" (Geels, 2011, p. 31).

2.2.3 Complementing the Extended Social Grid Model and the Multi-level Perspective

Because the MLP provides a background for analyzing the path from innovation to mainstream by distinguishing different analytical levels (macro, meso, micro) it is a good complement to the ESGM, which is particularly valuable as a heuristic means to structure a comprehensive picture of relevant processes for social change to occur independent of a certain level. As there is some overlap in both concepts, we argue that they can be meaningfully integrated with some minor adaptations, and that the analytical levels of the MPL model particularly help to understand the roles of competing social forces. We suggest that cognitive frames, social networks and institutions can exist and develop within each level (i.e. the niche, the regime and the landscape level), but that they can also span across different levels. For example, innovators in a niche might have strong social ties with actors on the regime level. Cognitive frames on the landscape level might be shared by niche innovators (or be entirely different), but their particular solution can still be at odds with the existing institutions on the regime level.

Beyond the different levels, the terminologies and suggested structure between the ESGM and the MLP might slightly differ. However, there are still very strong similarities. E.g., cognitive frames are very similar to the notion of cognitive routines. And the categories constituting the sociotechnical regime (*market user preferences, industry, science, culture,*

policy, technology) could be in principal extended with the ESGM categories (*natural, artefactual* (→ *technology* and *science*), *cultural*, (*economic* (→ comprises *market user preferences* and *industry*), *military-related, political*; following the NACEMP) without losing any substantial aspect and even widening the scope. What is more, the ESGM heuristic could even be applied for the macro and micro-level, given the general limitation of the ESGM framework (Cf. Deliverable 5.1, UHEI contribution). However, the presence of different social forces probably varies across levels. For example, institutions are probably weaker or less frequent in the niche, but depending on the analytical viewpoint, can still exist. For example, the housing system for employees of early industrialist Alfred Krupp (1812 – 1887) can be seen as an institution within the niche in which social housing as an idea developed (Cf. Scheuerle and Glänzel, 2015).

Table 1: Key concepts within the multi-level perspective on socio-technical transitions integrated with social forces as in the ESGM

Concept	Level	Description
Socio-technical landscape	Macro	*Cognitive frames, institutions* and *social networks* (NACEMP) constituting the background, e.g. deep cultural patterns or macro-economic developments
Socio-technical regime	Meso	Dominant *cognitive frames, institutions* and *social networks* (NACEMP), stabilizing the current functioning of the system, e.g. the dominant production or financing mode, ruling political networks, welfare state set up
Niche	Micro	Rising *cognitive frames, institutions* and *social networks* (NACEMP), flourishing in protected spaces where radical innovation can develop, e.g. new perspectives on financing social ventures, associations of niche actors

Source: Based on Geels (2002) and Geels and Schot (2007)

2.3. Social impact investing and Five percent philanthropy compared through the ESGM

In this chapter, we will compare *social impact investing* today and *five percent philanthropy* in the 19th century guided by the ESGM and the MLP framework. We are aware that this is not a symmetric comparison since we have a financing tool in a specific field (social housing) on the one side and social finance as an approach emerging in numerous fields today on the other. Nevertheless, we argue that the similarities of both phenomena overweigh the differences and may help to explain different development paths of social innovations and their support structures. The assumption is, however, that the fundamental cognitive frame is the same, namely the conviction that social problems can be mitigated and solved with a (financial) market logic.

2.3.1 Five per cent philanthropy in Victorian London in the 19th century

There was a whole plethora of companies practicing the FPP approach or some close relative in the second half of 19th London (Wohl, 1977, p. 146). Out of these we can distill at least two exemplary models of FPP: First, there is the approach practiced by the *Peabody Trust* founded in 1864, which was initiated and run by the wealthy American banker George Peabody (1795-1869). It involved the objective of a moderate annual net return even lower than five per cent, but rather for self-perpetuating and expansion of the trust than for making profits. The Trust aimed to employ its endowment economically and sustainably in order to "recycle" the capital as much as possible to help the poor, and there were no repayment obligations to shareholders in principal (Tarn, 1973). The second approach is closer to today's actual conception of social impact investing: The *Improved Industrial Dwellings Company* (IIDC) was founded by Sir Sydney Waterlow (1822 – 1906), son of a city stationer who worked his way up to the middle and finally upper class through setting up a major printing company; in 1872, he would become Lord Mayor of London. Having housed some 80 families as a private philanthropist before (Wohl, 1977, p. 149), he founded the IIDC with only GBP 50,000 starting capital but on the premise that it would pay investors their money back plus a five percent return; as a result, the capital grew vastly and reached GBP 921,500 by 1884 (ibid.). Set up as a *limited-dividend company*, this approach is at the core of five percent philanthropy and close to today's conception of (finance first) social impact investing (Hebb, 2013; Adam, 2002).

The approach spread fairly well in London (Wohl, 1977, pp. 145–146): In 1875, there were 3,300 dwellings built by the two FPP companies mentioned herein in the city area (1,800 by the Peabody Trust and 1,500 by the IIDC), and in 1895, that figure had risen to 10,450 (5,100 and 5,350 respectively) (Tarn, 1973, p. 58). By 1900, the Peabody Trust was housing 19,000 people, and Waterlow's Improved Industrial Dwellings Company housed even nearly 30,000 in its 45 estates (Wohl, 1977, p. 149). Although we do not have quantitative material that is precise for other major UK cities, we know that the approach was subsequently adopted in many of them, most notably in Liverpool, Leeds, Manchester, Birmingham, Glasgow and Edinburgh. The quantitative data available is very limited, but compared to London the figures are fairly small, a couple of projects and houses with a few hundred dwellings in each of the cities named above (Tarn, 1973, pp. 61-66; 89-94). However, later the approach even spread to continental Europe where the Leipzig merchant Gustav de Liagre was the first German philanthropist to use the FPP principles, purchasing two buildings with 240 rooms in Leipzig in 1883. He in turn inspired publisher Herrmann Julius Meyer who bought and rented 500 dwellings for a rent yielding 3% return which he reinvested in the approach (Adam, 2002, pp. 334–335).

In the following section, we will concentrate on the second approach outlined above, Waterlow's five percent philanthropy, and consider the Peabody Trust only where appropriate as a contrasting example.

2.3.2. Context, motivation and driving forces

When Sydney Waterlow set up the IIDC, social forces of the time were dominated by industrialization, the rise of a new class of bourgeois capitalist with distinctive values from the previous feudal system, and wide-spread ‘free’ market, liberal thinking. The transition from agricultural and rural societies to urban and industrialised ones in many European countries had caused structural pauperism and existential insecurity (Brakelmann, 1962; Tocqueville, 2007), which became particularly visible in an extremely poor housing situation with overcrowded and dirty dwellings. The reasons for and solution to this “housing question” were hardly understood. The welfare system was only dawning on the horizon, and housing was perceived as an individual responsibility. Furthermore, free-market-based solutions caused speculation and the unimpeded exploitation of the situation by many landlords (Fuhrmann *et al.*, 2008). Institutions such as rent controls, building regulations, or enforceable hygiene standards were hardly existing, relatively weak, or even counterproductive, and infrastructure improvements were not undertaken (Chadwick, 1842, p. 5).
A range of social reformers from the upper and middle classes, however, was very much interested in politics and in the social problems of communities. And also there was a quite widespread belief in “philanthropic capitalism” (Wohl, 1977, p. 141) and its ability to tackle social problems by steering “investment into philanthropic channels” (ibid.). It needs to be emphasized that charitable activity was very much supported and a significant constituent of the Victorian “Zeitgeist”. For instance, in 1861 London charities had an aggregate income of almost GBP 2.5 million, and by the end of the 1880’s this figure had even doubled. As a result, there was a whole plethora of different approaches and ventures competing for that capital (ibid.).

With his business background, Waterlow sought to show that housing for the laboring poor could be provided by doing business according to strictly set economic and carefully defined architectural guidelines. These became the core of the FPP approach and the central ingredient to its (temporary) success. Waterlow summarises the rationale behind his approach:

> “All I have endeavoured to show is that capital, expended in the erection of light, cheerful, healthy habitations for the industrial classes in crowded cities, may be made to yield a fair interest on its investment, if care is taken to avoid extravagance in external architectural decoration or loss by large management expenses.” (Tarn, 1973, p. 52)

In consultation with builder Matthew Allen, he intended to produce a housing unit that could be be built easily, let at a suitable rate[6] to beneficiaries, and generate a profit of five-per-cent

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[6] In rural England of the late mid-19th century, the average rent was about 1s 6d per week; for the same space in London, dwellers had to pay 4s 6d or more Wohl (1983, p. 304); wages for common workers in London varied between 12s and 15s a week (http://www.victorianweb.org/science/health/health9.html). Engels (1845, p. 128) reports of a case where workers earning 11 shillings and 4 pence a week had to pay 4 sh. 4 p. for rent, heating and lighting (also see Scheuerle *et al.* (2015)). Another source speaks of 2-5s Morris (2001).

for the owner. By doing this, Waterlow hoped to convince his friends that they might invest their money in a good cause (Tarn, 1973, p. 51). The motivation to solve the problem with business means was also shaped by two contextual circumstances typical for the Victorian age: First, the success of many of the business people who had come to wealth through the rise of capitalism led them to seek some form of ethical “compensation”; and second, state involvement was more or less unthinkable.

Concerning the first context variable, a five per cent return was rather little as compared to the standards of these days (Wohl, 1977, p. 142), providing successful businessmen with the chance to do something as compensation by becoming FPP investors, making it a particularly Victorian habit (Tarn, 1973, p. 43). The approach was also designed to attract capital from those wealthy individuals who otherwise disapproved of charity, but would be more inclined to take part in a more entrepreneurial approach which would also yield a small return (Wohl, 1977, p. 142). Thus, a central element to the FPP approach seems to be traceable to a *cognitive frame* (Nicholls and Ziegler, 2014; Beckert, 2010) which was shaped by a) sort of a “bad conscience” among business men because of their success in the free market economy and b) a free market economic spirit with some significant degree of aversion to state interference and charity. The “bad conscience” aspect is a psychological mechanism that seemed to be rather new at the time compared with Western history through which donating some income *unconditional* of the level of that income was a cultural constant, but “giving something *back*” (i.e. making charity conditional upon one’s own business success) is not very widespread (Sedlacek, 2011).

The second context variable lay in some form of “negative” motivation, i.e. within the cognitive frame of free market thinking it was *not* conceivable at that time that the state or any public body should solve the housing problem or any other problem of the poor. An intervention at the regime level of the housing market such as subsidization was not part of the dominant cognitive frame. It was common sense among everyone who got involved in thinking about these problems that a solution should be found by means of private initiative (Tarn, 1973, p. 44)[7]. FPP was supposed to be a third way, in between business solutions that end up in speculation and philanthropy incapable of solving a problem with such massive scale.

Overall, the approach with its innovative combination of philanthropy and capitalism had great appeal in the popular press, reform literature, and even the Royal Family (Wohl, 1977, p. 145). It was often presented as a panacea and in 1862 even an anonymous poem praising its merits appeared in the City press (ibid.: 142-144).

2.3.3 Investment fields, transactions and ecosystem

Waterlow’s FPP was built as a *limited liability company*, where investors became direct owners of the housing facilities or building projects. There were no investment intermediaries

who would help them set up investments in fields where investors did not have solid business expertise (as is the case with SII today) or who would structure and administer financial and business activities, i.e. there was no real institutionalisation of the field (Nicholls and Ziegler, 2014; Fligstein, 2001; DiMaggio and Powell, 1991). These responsibilities were assumed by Waterlow and the Trustees themselves, all of whom were highly respected and valued members of society. That raised the cultural power of the movement enormously (Tarn, 1973, p. 48), enabling them to access elite networks which – alongside many other less "concrete" effects – helped in the acquisition of land at attractive prices (Wohl, 1977, p. 145).
Accordingly, the promoters of FPP had access to powerful social networks on the regime level.

Like venture philanthropists and some impact investors (or their intermediaries) today, they also actively engaged in ensuring their investment and management policy were "free from scandal and accusations of mal-practices"(Tarn, 1973, p. 55). Moreover, they had profound knowledge of the housing market and could estimate from their experience what return was possible. This may be part of the reason why the IIDC (and other FPP investors) concentrated their investment activities in fields where they knew their approach would work. In turn, this meant they excluded those parts of the housing market where their approach would not fit, essentially entailing two main considerations: one on the *cost* side and one on the *revenue* side. On the cost side, the FPP approach very much built on a strict *business case orientation*, i.e. FPP investors and managers took very seriously the premise that every activity pays off and does not cause losses. In this context, it turned out that low-cost building depended in particular on acquiring building land at low cost. To achieve that FPP builders had to find ways to make attractive bargains which were not available on a regular basis or let alone in the required quantity to make a difference given the size of the problem, or they had to develop ways to acquire land on a more regular and predictable basis. For a certain period, the *Metropolitan Board of Works* (the public body responsible for regulating housing and infrastructure in London) was primarily involved with implementing numerous schemes under the two *Metropolitan Acts* of 1866 and 1875 aiming to clear the slums in the city. Under the second Act alone, it cleared some 42 acres of slum property, displacing more than 23,000 people while at the end rehousing almost 28,000 in close co-operation with housing companies such as the IIDC. For them, the major result of the slum clearance schemes consisted in land that they could acquire at very favourable prices. In MLP terminology we might say that the crisis on the landscape level (slum building) opened up possibilities for social innovators on the regime level (favourable legislation and public administration leading to attractive buying conditions for land) (Geels and Schot, 2007).

Overall, the involvement of the state and the Metropolitan Board was very important to the FPP movement. Probably one of the crucial success factors was the fact that the model dwelling companies could borrow capital from the state for 4%, repayable over 40 years. Waterlow's company borrowed GBP 84,000; overall by 1875, GBP 250,000 had been lent to the model dwelling movement. It is reasonable to say that these "government loans represented unpublicised subsidies to the constructors of model dwellings" (Wohl, 1977, p. 144). A second "subsidy" was less planned, as in total the Board "lost" more than 1.3 million

GBP on the sale of the sites acquired in the course of its slum clearing schemes compared to market prices. These prices could not be achieved, and the resulting loss can be seen as another indirect subsidy to the building companies. In turn, they faced tight regulation concerning building standards from the Board (Tarn, 1973, pp. 83–88). But overall, these very low land and capital prices and costs were central ingredients to the success of the FPP approach on the cost side (ibid.; Wohl, 1977, pp. 144–145)

On the revenue side, the IIDC concentrated on those shares of the market where sufficient revenue from rent could actually be made and charged about 2s in the 1880s (Morris, 2001, p. 534). That meant in terms of beneficiaries concentrating on those working poor who were not too poor to pay a rent high enough for the requirements of the IIDC's business plan at the expense of those actually living in extreme poverty. Yet, it might be overstating the business orientation of the approach to say that they were excluded on purely economic grounds. Instead, this approach was chosen to maximize social impact: The rationale (or the cognitive frame at work in this niche of FPP actors) was that if the money invested goes into a business venture from which it will flow back to the investor, then it can be used repeatedly – thus overall and in the long run the capital employed can make more impact. In other words: FPP investors "believed their greatest and most effective contributions could be made at this particular level in society and with the approach they adopted." (Tarn, 1973, p. 48) So although FPP actors had considerable economic power, it was not unlimited, leading to two interwoven strategies: (1) the capital had to be "recycled", i.e. repaid + 5%, in order to let future generations benefit from it too ("the approach they adopted"); and (2) the most marginalized could not be targeted, while standards like comfort or privacy (but not security and hygiene) had to be compromised in order for the approach to be economically sound (Wohl, 1977, p. 150). Waterlow replied with a third and fourth argument to contemporary critics of this pragmatic approach: (3) "it would not have been right to build down to the lowest class, because you must have built a class of tenement which I hope none of them would be satisfied with at the end of 50 years; [4] we have rather tried to build for the best class, and by lifting them up to leave more room for the second and third who are below them." (Tarn, 1973, p. 53). So he already employs what is nowadays called a *trickle down* or *elevator effect* (Beck, 1986, pp. 121–160) argument in a wider sense, an economic mechanism assumed to be active and working well within the cognitive frame dominant among the FPP actors involved here.

2.3.4. Financial performance and impact on capabilities

Although financial data concerning the performance of Waterlow's and other FPP actors' endeavours is scarce, we can say that apparently they were successful as indicated by the growth in both the capital invested and the number of people housed, as described above. From their beginnings in the early 1860's on, Waterlow succeeded in building and managing dwellings in a way that allowed him continuously to pay the envisaged 5% dividend to investors (Wohl, 1977, p. 151; Morris, 2001, p. 536). That suggests that the model worked economically under the circumstances for which it had originally been developed. Later on, beginning with the 1890's, increasingly unfavourable and costly requirements from the

Metropolitan Board made costs rise at the same time as there were increases in the price of land.

The way the IIDC built and managed its dwellings and its invested capital had a strong influence on worker beneficiaries' capabilities. First and foremost, they had roofs over their heads and clean, secure and often also significantly better lighted buildings. Before, they often lived in overcrowded, shared rooms and slums where families accepted additional tenants sleeping in their beds for certain hours to improve their rent ("Bettgeher"), and there was usually only one room that was used for cooking, eating, sleeping, or having sex (Fuhrmann *et al.*, 2008). In this way, a very basic capability was improved (Nussbaum, 2011, p. 33). In terms of measurable social impact we can refer to the death rate among IIDC inhabitants which was very much lower than for London as a whole: only 17‰ as compared to 22‰ (Wohl, 1977, p. 151). That may be attributed to the fact that Waterlow and his partners also took care of hygiene (and thus health) and privacy standards as additional elementary capabilities. They built dwellings with separate flats for families, each with their own sculleries. This was in contrast to Peabody's approach which featured shared bathrooms for entire floors. And although the buildings of the IIDC might not look very attractive from today's point of view, they marked a significant aesthetic improvement compared to earlier dwellings of the working poor, showing also respect for their dignity.

Overall, however, there was nothing like a sound "impact assessment" made, let alone one which would let us assess the impact which the FPP approach or even social housing in general had on the capabilities of the working poor. Nevertheless, one can say that even though the FPP approach was successful to the extent it was practiced, that very *extent* lagged far behind the size of the problem (Wohl, 1977, p. 151). Therefore, it did have some impact, but compared to the overall problem, it can be seen as rather limited (just as is the impact of SII today compared to the problems it aims to tackle): "For the few who were lucky enough to *obtain* a model dwelling and were able to pay the rent, it did very often mark a turning point in their lives, but London continued to grow in size far faster that good cheap new housing could be built (…)." (Tarn, 1973, p. 61).

2.3.5 Social impact investing today

In contrast to FPP, SII has quickly become a global phenomenon with specialized actors spanning across developing and developed countries as well as across different themes. As well as affordable housing, it includes for example financial inclusion, employment and inclusion, economic development, health, sustainable energy, agriculture or education (GIIN and Cambridge Associates, 2015; Social Investment Research Council, 2015). Different studies suggest that there are several hundred SII funds today. The ImpactBase of the *Global Impact Investing Network* (GIIN; see below) listed 310 funds in April 2015 (286 of them funded after 2001), of which 153 exclusively invest via private equity and venture capital, and 63 use multiple instruments (Mudaliar and Barra, 2015, p. 2). The investment consulting company *Cambridge Associates* runs a Mission-Related Investing (MRI) database with 579 private MRI funds of which 392 are private equity or venture capital funds. And this does not

include the direct investments of private business angels or family offices[8]. Those funds (also referred to as social investment financial intermediaries (SIFIs)(Social Investment Research Council, 2015) vary considerably in size and scope, however. While more than half of the private equity and venture capital funds have a capital endowment of less than USD 20 million (Mudaliar and Barra, 2015, p. 4), pioneers in the field have grown beyond USD 2,6 billion of investments (ResponsAbility, 2012) and invest up to USD 10 million in one organization (LGT). Moreover, of the 153 private equity and venture capital funds from the impact database, only 17 exclusively invested in Europe, most of them in the UK (Social Investment Research Council, 2015). The main investment field statistically is financial inclusion (GIIN and Cambridge Associates, 2015), which is apparently the most straightforward cause for SII.

While the data generally indicate that the field is growing, early optimistic estimates that saw a potential investment volume of US$400 billion to US$1 trillion until 2020 (O'Donohoe *et al.*, 2010) have recently been judged more skeptically (Alto, 2012; Oldenburg and Daub, 2016; Petrick and Birnbaum, 2016), and the future directions for the spread of SII are still under discussion.

2.3.6. Context, motivation and driving forces

The idea of investing money for social purposes never disappeared, but diversified even more over time and was adopted in aspects of social finance such as micro credit and socially responsible investing (Barnett and Salomon, 2003; Johnsen, 2003). This shows on the one hand that the idea of leveraging financial assets for the social good is a live and continuously practiced major social innovation on its own (Nicholls, 2010). On the other hand, the particular idea of SII can be seen as closely interlinked with the increasing emphasis on market-based approaches to social problems, expressed in the idea of social entrepreneurship (SE) (Austin *et al.*, 2006; Dees, 2001; Mair and Marti, 2006). Not a new phenomenon[9], social entrepreneurship has been attributed with the potential to develop new and innovative solutions for social problems, often by developing a source of market income to increase the self-sufficiency of problem-solving approaches (Di Domenico, Maria Laura *et al.*, 2010; Dorado, 2006). SII can be seen as an instrument to create beneficial ecosystem conditions for such ventures that is – as many measures in the context of SE – borrowed from the business domain.

Entering social networks

SII entered Europe through *social networks* created at the intersection of two fields or, more specifically, two developments within specific fields. On the one hand, in the social sector

[8] However, approximately 75% of investors invest via intermediaries, regardless of whether they also invest directly in companies Saltuk *et al.* (2015).
[9] In fact, SE can be traced back at least to the 19th century with people such as Florence Nightingale, Maria Montessori, Friedrich Wilhelm Raiffeisen or Herrmann Schultze-Delitsch, engaging in fields of community building, care, work integration, education, protection of environmental resources and further social services.

there has been an increasing trend since the 1990s amongst private foundations with a more liberal welfare understanding[10] to apply business-driven methods for promoting innovative social purpose organizations. Those methods were in particular borrowed from the field of venture capital and lead to the rise of “venture philanthropy” (Letts *et al.*, 1997; van Slyke and Newman, 2006) or, as some critiques phrased it, “philanthrocapitalism” (Bishop and Green, 2010; Bishop, 2006; Edwards, 2010). To make their approaches even more efficient, those actors partnered with actors from the classical market domain, where the idea of corporate social responsibility had been on the rise since the high times of shareholder capitalism in the 1980s (Dyllick and Muff, 2015). What is more, employees are increasingly motivated by post material values and want to do “meaningful” work, causing an increasing interest of young, well-educated persons from the business domain in fields such as SII.

Unifying cognitive frame

The *cognitive frame* that tied these networks together was the idea that social problems needed to and could be addressed by (social) entrepreneurial means more efficiently and effectively than by the status quo of established welfare systems. SII was seen to fill the finance gap in the scaling process from small and local initiatives to spreading an innovative approach nationally or even internationally (Bugg-Levine and Emerson, 2011; Grabenwarter and Liechtenstein Heinrich, 2011). Both regular public financial support as well as private funding such as foundation grants or donations were not sufficient in their amount and flexibility for this purpose (Achleitner *et al.*, 2013; SEFORIS, 2014; Glänzel *et al.*, 2012). What is more, innovative social enterprises’ capital needs often are at odds with regular social welfare provision and thus have problems in accessing financial capital at all(Scheuerle and Schmitz, 2015). From the investor perspective, the SII idea implied that the repayable money could be re-invested again to create even more social value (Leßmann and Schirwitz, 2008). Even more, there was a possibility to earn an interest rate while doing good.

Prevalent developments – economization of the social sector

This background is interesting for different reasons. First, the welfare systems in many European states have reached a very mature stage in comparison to the 19th century, and also differentiated in regard to their *institutions* and dominant *social networks*, guided in turn by *different cognitive frames* (Esping-Andersen, 1990; Henriksen *et al.*, 2012). Within these systems, earned-income approaches (with centrally negotiated, fixed service fees) have been a constitutive part of many welfare states. For instance in the ‘corporatist welfare’ regime in Germany, it is usual for public purpose limited liability companies (*gemeinnützige GmbHs*) or cooperatives (*Genossenschaften*) to generate the majority their income from regular

[10] Three ideal types of welfare regimes can be distinguished according to Esping-Andersen’s (1990) seminal work: ‘social-democratic’’ regimes providing extensive public services in an universal approach that serves all members of society based on high taxation, with nonprofit organizations as supplementary service providers (e.g. Denmark), ‘‘corporatist’’ regimes characterized by close partnership between nonprofits mainly as service providers and the state on an insurance-based system (e.g. Germany), and ‘‘liberal’’ regimes with little public support for social services and strong philanthropic engagement (e.g. the UK, the US)

markets or public quasi-markets (Priller *et al.*, 2012). The same holds true for all other types of welfare states (SEFORIS, 2014). Even more, in the last decades in nearly all European welfare states on both the *regime* and *landscape* level, there has been an increasing dynamic towards more efficiency, competition, and free consumer choice through market-oriented solutions for social issues (Henriksen *et al.*, 2012), as claimed by the *new public management* (Hood, 1991; Rhodes, R. A. W., 1996)[11] approach. This holds true to different extents for all fields of activity that are typically associated with the "social sector", such as social services[12], health care, or education. Also specific credit-based financing instruments and institutions have already been established, such as the *Bank für Sozialwirtschaft* in Germany or *Charity Bank* in the UK.

Prevalent developments – elite networks

Second, albeit *social networks* promoting SII are comparably small, the actors are part of or have access to elite power networks in the economic and political domain (Wohl, 1977, p. 145). From the perspective of public bodies, the idea of leveraging public money by means of additional private capital to support public causes is particularly attractive. Accordingly, the idea of SII has risen comparably rapidly on public agendas across Europe and beyond. It was picked up and discussed by different states, the OECD (Wilson, 2014), and the European Union (Glänzel *et al.*, 2012; European Commission). When the presidency in the former G8 (now G7) turned to the UK, British prime minister David Cameron also established the *Social Impact Investment Taskforce*[13] in late 2013 that bundled and promoted national multi stakeholder initiatives to review possibilities for (increased) local adaptation of SII (Social Impact Investment Taskforce, 2014). Those national advisory boards comprise investors and intermediaries, politicians, researchers and social sector representatives. In August, the *Global Social Impact Investment Steering Group* (GSG)[14] was established as a successor with members from 14 countries, including also Australia, Brazil, India, Israel, Mexico, Portugal, and the EU.

2.3.7. Investment fields, transactions and ecosystem

When it comes to the concrete implementation of SII, emerging and changing *institutions*, *social networks*, and *cognitive frames* within the *niche* of the SII community can be observed, which also reach out to or resonate with some more general social forces on the *regime* or *landscape* level.

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[11] Some scholars have even argued that there might be a trend of convergence amongst different welfare regimes in response to similar problems, although research has also shown that the influence of different welfare traditions and structures still result in slightly different outcomes, e.g. regarding the role of organization from the third sector Henriksen *et al.* (2012).
[12] What is understood under social services differs from country to country, usually covered, however, are community care, family counselling services, youth and elderly care, and in most cases also services for mentally ill and disabled persons or job training programs Henriksen *et al.* (2012, pp. 462–463).
[13] https://www.gov.uk/government/groups/social-impact-investment-taskforce
[14] http://www.socialimpactinvestment.org/

Policies

Most visible are policy initiatives on the national and international level aiming at supporting and *institutionalizing* SII. Amongst the most prominent examples are the *Big Society* initiative[15] under the conservative Prime Minister Cameron in 2010 that intends to strengthen the role of civil society organizations in social service provision[16] and comprises its own SIFI (*Big Society Capital*) following SII principles for this goal, or the "90-10" scheme in France that obliges companies to invest 10 per cent of their employee savings in government-recognized solidarity companies or revenue sharing funds (Jégourel and Maveyraud, 2008). In Germany, the German Federal Ministry of Family, Senior Citizens, Women and Youth commissioned the public bank *Kreditanstalt für Wiederaufbau (KfW)* in 2011 to develop a 'promotion programme for social enterprises' that works as a 'matching fund' with a private lead investor, which however has since (2014) terminated. The European Union is also very active, witness its *Regulation on European Social Entrepreneurship Funds*[17] designed to promote social impact investing by defining core criteria and a specific status for such funds. It also set up its own investment vehicle, the *Social Impact Accelerator* (SIA)[18] in 2013.

Enabler associations, intermediaries, etc.

But there are also other signs of continuing *institutionalization* of the field, at least in some countries. One sign for the development towards more maturity in the field is the setup or evolution of different intermediaries and associations. Marketplaces for social impact investing with a variety of "enablers" beyond the actual SIFIs are emerging in different countries, although at a different pace (Alto, 2012; Guézennec and Malochet, 2013; Koh *et al.*, 2012; O'Donohoe *et al.*, 2010). They provide consulting for both social enterprises to get "investment-ready" (Gregory *et al.*, 2012) and investors new to the field, provide data in a specific field (Petrick *et al.*, 2014; Petrick and Weber, 2013), or connect capital providers and investees. Also established actors like ethical banks or increasingly institutional investors set up responsibilities for the topic. And also associations have been emerging. For example, the *Global Impact Investing Network (GIIN)*[19], founded in 2009 on the initiative of the Rockefeller Foundation to promote the field of impact investing in general by strengthening *social networks* amongst organizations interested in impact investing. Also, the *European Venture Philanthropy Association (EVPA)*[20], founded by individuals with a background in private equity, increasingly put the focus on repayable funds over time, as the structure of its now over 210 members and annual gatherings show. These organizations not only offer tools and trainings and facilitate knowledge exchange even at high profile conferences such as the

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[15] http://www.bigsocietycapital.com/
[16] The initiative promotes the increased freedom for private initiative and volunteerism in social issues. As it went along with considerable cut backs in public spending in these fields, it has been criticized as actually following a neo-liberal doctrine while hiding behind civils society talk.
[17] http://ec.europa.eu/internal_market/investment/social_investment_funds/index_en.htm
[18] http://www.eif.org/what_we_do/equity/sia/index.htm
[19] https://thegiin.org/about/
[20] http://evpa.eu.com/

World Economic Forum and other events; they also provide intelligence in the field and are involved in policy making processes.

Data availability/research

Generally, knowledge is also further *institutionalizing*. The data situation was initially weak but has lately been improved by different analysts, with various investor surveys and databases (Hehenberger *et al.*, 2014; Mudaliar and Barra, 2015; Saltuk and Idrissi, 2014; Saltuk *et al.*, 2015), national or regional reports (Guézennec and Malochet, 2013; Heap and Davison, 2014; Petrick and Birnbaum, 2016), investment field specific reports (Emerson *et al.*, 2007; Petrick *et al.*, 2014; Petrick, 2013)and recently two benchmark studies – a typical *institutional* element of conventional financial markets – that were published concerning the financial performance of SII funds across the globe and in the UK since the late 1990s (GIIN and Cambridge Associates, 2015; Social Investment Research Council, 2015). Also there is a huge amount of practitioner publications (Achleitner *et al.*, 2011; Balbo *et al.*, 2008; Cummings and Hehenberger, 2011; Shortall and Alter, 2009) as well as an increasing field of academic research(Daggers and Nicholls, 2016). Further, teaching formats are beginning to enter major, often high profile universities.[21]

Challenges

Despite the fact that SII seems to be in line with *cognitive frames* in fields of social policy and also the business domains on the landscape level, there are still some issues for implementation (Emerson *et al.*, 2007; Freirich and Fulton, 2009; Glänzel and Scheuerle, 2015; Gregory, 2013; Martin, 2013; Saltuk *et al.*, 2015). Only few investors such as high net worth individuals (HNWIs), family offices, institutional investors, foundations are familiar with the concept of SII, indicating that SII is still mostly in the niche and has not fully entered the regime level yet.

Infrastructure

One of the key problems is the still insufficient institutionalized infrastructure in many countries. This causes high transactions costs, particularly given the fact than social impact investments are usually much lower than their commercial counterparts, for example, in Germany with an estimated average of 10-15 deals of over €100,000 closed per year (Petrick and Weber, 2013) . Based on an analysis of more mature markets, (Gregory, 2013, p. 4) lists as elements of a supporting infrastructure "brokers and advisors, product developers, data and information providers, research houses, product reviewers, mechanisms for collaboration, a trade body, education, skills and training providers, rating agencies, platforms and exchanges." He also emphasizes, however, the necessity of high governance, ownership, transparency and accountability standards in the field, as well as clarity about whether investors are primarily driven by financial or social motives. Other authors emphasize the

[21] http://www.sbs.ox.ac.uk/programmes/execed/iip

need for primary and secondary exchange platforms where shares can be exchanged (Mendell and Barbosa, 2013) and stress the lack of adequate 'pipelines' for investments among intermediary organizations (Brown, 2006; Emerson *et al.*, 2007; Freirich and Fulton, 2009; Moore *et al.*, 2012; Weber and Scheck, 2012).

Impact measurement

A crucial problem in this respect is the question of how social value is measured and valued in financial terms. For some stakeholders, this is necessary to show the social impact achieved, but also during the investment decision in the due diligence process and the valuation of social enterprises (Alemany and Scarlata, 2010; Evans, 2013). Investors still apply different metrics here, amongst which the most prominent ones are IRIS[22] or SROI[23], but to date all of them impose high transaction costs particularly on the investees (Clark *et al.*, 2012; Glänzel and Scheuerle, 2015; Jackson, 2013; Meehan *et al.*, 2004; Repp, 2013).

Investment readiness

One of the major problems seems to be also the investment-readiness of social enterprises. Data from 2012 show that experienced impact investors such as Acumen Fund or LGT Venture Philanthropy have invested in under 1 per cent of the several thousand social ventures they had reviewed, and even within this subset, only a small proportion have been operating at scale (Alto, 2012).Overall, investment-readiness in terms of (potential) investees' capability to repay an investment at market or even below-market rates of return seems to be fairly limited (Glänzel *et al.*, 2013). Several authors showed that lacking management skills as well as the absence of real business cases (Glänzel and Scheuerle, 2015; Moore *et al.*, 2012; Spiess-Knafl, 2012) can be problems that are hard to overcome. In consequence, there is a risk that impact investing – seen as a seductive idea for doing good while making returns – will attract both social enterprises and capital providers that might be better off working with grants, etc.

Relationship

Further, there is a problem that in contrast to the previous ones rather refers to social networks and cognitive frames. Personal *relationship* between investors and investees may be burdened by different value dispositions and biographic backgrounds as well as autonomy issues (Achleitner *et al.*, 2013; Glänzel and Scheuerle, 2015).

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[22] **I**mpact **R**eporting & **I**nvestment **S**tandards of the Global Impact Investing Network; www.iris.thegiin.org/about-iris

[23] **S**ocial **R**eturn **o**n **I**nvestment; a recent study has shown that the UK has so far been the World's most SROI-affine country with the vast majority (70) of all 118 SROI analyses conducted between 2002 and 2012 having taken place there. Nevertheless, the absolute numbers of mere 70 in the UK, five each in Austria and the Netherlands, and three in Germany underscore that this method is not very widespread in Europe so far (even in the US where the resource-intensive SROI analysis was invented, so far only seven full-scale SROIs have been conducted) Krlev *et al.* (2014).

2.3.8 Financial performance and impact on capabilities

Available data suggests that SII funds perform comparably well in financial terms in comparison to SME data of commercial investments, which is relatively successful considering the fact that the analyzed data comprises the financial crisis starting in 2008 (GIIN and Cambridge Associates, 2015; Social Investment Research Council, 2015). The total turnover, however, is still comparatively low and illustrates the niche character of the SII. In Germany, in 2014 there was a total amount of EUR 6,400 billion, about EUR 60 billion socially responsible investments, and only about EUR 0.07 billion of SII (Oldenburg and Daub, 2016). However, the amount of capital that can be invested had risen from EUR 0.024 billion since 2012 (Petrick and Birnbaum, 2016).

On the other hand, social performance data that could give insights on changing the capabilities of the addressed beneficiaries are hardly available, not surprisingly given the measurement problems illustrated above. Actors in the field have criticized the fact that the focus regarding data is currently more on the financial performance aspect.

2.4. Learnings and Discussion

Comparing FPP and SII through the lens of the ESGM and the MLP can help to deepen our understanding of why the idea of applying financial investment logic to social causes might or might not move from a niche to the regime level in society. Comparing both cases in terms of the different aspects of our analysis indicates that SII today might be a better way to achieve a broader diffusion and more social impact than FPP, mainly because it is backed by more promoting cognitive frames and powerful social networks on more societal levels, but also because it is about to develop a more solid institutional base. However, there are also substantial barriers that can be identified.

The first major difference between now and then is that today there are *cognitive frames* in place that support the claim that solving social problems is a *societal* responsibility (not one of markets or private philanthropic initiative). To a certain extent, this is (or has been) a shared conception (until) today – although far from what was public opinion in the Victorian age. As a result, there is a common understanding that social problem solving deserves broad societal support, and that cognitive frame is of course supportive for SII which is an advantage of that approach over FPP.

In contrast, a *cognitive frame* that both approaches *share* consists in the idea that social problems need to and can be addressed by (social) entrepreneurial means efficiently and effectively. This is what efficiency and cost pressures today and a belief in and excitement for market-based approaches then have as a common result: Today, the argument goes that we *have to be* cost-effective; back then, the argument was that FPP actors *wanted* to show that market-based strategies work well for social problems. However, cost-effectiveness and efficiency is and was paramount in both approaches, yet the outcome and impact are

different, because the means-ends relationship is different between FPP and SII: The first comes in with an approach, i.e. the goal to show that social housing can be provided by developing and implementing a working and sustainable business model; to showcase is the final end, while social housing is one of the means. In contrast, SII is based on a heritage of social problem solving first (ends) with increasingly entrepreneurial approaches (means) coming later in the form of social entrepreneurship; in its current form, the “impact first” SII variant emphasized herein thus features a relationship of means and ends in which the social problem is the end while its support via investment in social entrepreneurship investees is (part of) the means. In contrast, in this terminology the FPP approach translates more into a “finance first” form of impact investing with all its consequences.

The most serious and far-reaching consequence is that the strict business case orientation led to the most marginalized not being targeted and reached. Overall, although it was an economic success (Morris, 2001), the FPP approach can be said to have failed as an attempt to solve the social housing question it initially stepped up against (Wohl, 1977, p. 176). In terms of the ESGM, social impact in form of enhanced capabilities of the marginalized had not been part of the *cognitive frame* on which the approach was built. Consequently, probably the most important learning is that the approach failed to improve the capabilities of the marginalized but also never set out to do so, as the cognitive frames at work within the networks of FPP actors were instead shaped by business logics and market liberalism. Modern SII, in contrast, puts much more emphasis on social impact and its measurement, particularly at the niche level, even if it is a “finance first” variant. Thus, the preconditions to achieve at least some form of social impact are much better, because social impact is a decisive constituent of the cognitive frame on which SII is based. This is enhanced by *social networks* spanning from the niche to the landscape levels within which modern investors are integrated: They are much more under observance from all types of stakeholders, all of them asking critical questions about the social impact achieved by SII.

In contrast, overall it can be stated that the Victorian cognitive frames shaping and surrounding the FPP approach did not contain the notion that social problems are a societal responsibility. Therefore, although the approach worked economically, it could not attract additional capital in order to tackle a problem of the size of the demand for working class housing. Thus, it remained successful at the niche level, but wider cognitive frames were not favorable enough for the approach to take hold.

The second major difference between FPP and SII obviously consists in the *institutional* environment of contemporary SII: First, there are (mostly) functioning social welfare systems existing today, and second the ecosystem is much more developed (although still far from being fully or even adequately developed). As a result, the entire institutional landscape level is very much different and much more promoting today. This is expressed at the regime level where there is a vast and powerful system of resources flowing into solving or reducing social problem institutionalized. In principle, everyone involved in social problem solving can benefit from that (although in practice there are regulatory and bureaucratic hurdles), including social entrepreneurs and their investors. The institutions, networks (associations),

and even first regulations outlined above are already working on the regime level as a precondition for the SI to grow beyond its niche. In contrast, no such favorable regime level conditions were in place for the FPP approach. Today, social networks between the SII niche and the regime level are stronger, despite the fact that FPP actors also had very good connections to local policy-makers. But the cognitive frame element stating that social problems need to be addressed by society as a whole shapes those relationships within contemporary social networks in enhancing their social impact orientation, whereas at the time of the FPP approach, shared cognitive frames were more business case oriented. Thus, whereas there is direct and open support for SII on all societal levels, FPP was only supported in indirect and often even concealed ways. Ideas of mixing social and business means and methods to improve efficiency and effectiveness of social problem solving (public money leverage, capital "recycling" instead of philanthropic spending, etc.), have entered into and shaped contemporary institutions surrounding SII.

In addition it needs to be noted that also a single policy promoting SII can be a strong game changer. France as another country with strong welfare institutions showcased that with establishment of the "90-10" scheme. As a result, a huge amount of capital became available to be invested in government-recognized solidarity companies or revenue sharing funds(Jégourel and Maveyraud, 2008). Many institutional investors did not have the expertise necessary, so the field had to be built more or less from scratch, with innovative social organisations taking the lead (Scheuerle, 2014).

2.5. Conclusion

Both the *impact orientation* within the cognitive frame on which SII is based and the tight and large *social networks* within which it is practiced nowadays (and in which the impact orientation is shared and reinforced) are major success ingredients in modern SII. Both factors were absent or not as strongly developed at the time of the FPP phenomenon. And also today we see some pull factors from the regime level (policy makers) and push factors from the niche, with networks often spanning across both. Overall, one might cautiously hypothesize that SII might be on the way to mainstream (about to leave the niche), but that also depends on the country one is talking about. FPP in contrast was too weak to reach mainstream, because networks and institutions were not sufficiently developed: Although the approach worked economically, it could not leave its niche, because wider cognitive frames would not be supportive enough. As a result, the approach worked only in a very small niche, and that niche did not even include the most marginalized. In terms of social innovation, we can thus call it a failed approach. This may be an important learning for those contemporary forms of SII subsumed under the "finance first" label. What is more, the approach of combining entrepreneurial and investment methods to solve social problems practiced by FPP actors appears to have failed to act as a precursor to later forms of social impact investing. Instead, it was more or less forgotten and had to be re-discovered and developed after WWII.

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3. Financing of Social Housing

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3.1. Introduction

Municipal, non-profit housing exists in most of the EU Member States, often called communal housing, and often provided by private developers (Ammon 2014: 7; Scanlon et al. 2015; 10). Though comparisons might at times be difficult, we find common features in Austria, the Netherlands and in some Scandinavian countries having a high share of communal housing, targeting large parts of society. In the literature we find terms such as "limited-profit", non-profit, gemeinnützig (social profit). These concepts are to some degree market-oriented, with a social conviction, organized under private law but state-controlled; and the small profits generated are reinvested into the cycle of residential construction and maintenance. (Amann 2014: 8). In this paper we are selectively highlighting the latest developments in some EU Member States against the background of EU policies for the sector and the credit crunch of 2008 which hit the housing market very hard and gave incentives for some policy changes with regard to funding measures.

3.2. Financing of Social Housing and EU Regulations

The funding of social housing (or community housing) in accordance with the EU subsidiarity principle is subject to national housing policy. In some strongly federal EU countries such as Germany and Austria, specific regulations differ in the various states. However, over recent years, a number of EU directives have caused some discontent among housing policy makers and related actors due to attempts to restrict national sovereignty in the field. Such resistance stems from the European Parliament (EP 2013 http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+REPORT+A7-2013-0155+0+DOC+XML+V0//EN#title1), the European Economic and Social Committee (EESC 2013), the Committee of the Regions (CoR 2012), the Federal Council of Germany (Bundesrat 2011), the Association of Austrian Cities, Towns and Local Authorities (ÖStB 2013) and the mayor's initiative for social housing (initiated by the Vienna mayor Michael Häupl together with some 30 mayors of big European cities) (SPOE 2014). They are all protesting against the European Commission's attempt to influence social housing policies.
EU regulators – and also some free market advocates in the housing sector – see EU Competition law and state aid rules infringed by national and regional housing policies. They claim additional breaches against national laws to implement climate protection and energy directives, capital market regulations and procurement laws as well as some macro-economic alert mechanism that some states have implemented in response to the real estate crisis (Streimelweger 2014).

Article 107 of the TFEU rules:

> *1. Save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.*
> *(http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:12008E107&from=EN)*

Subsidies for the social housing market fall into this category. However, in order to make social housing possible in spite of this regulation, Article 106, paragraph 2 of the TFEU foresees an exception:

> *2. Undertakings entrusted with the operation of services of general economic interest or having the character of a revenue-producing monopoly shall be subject to the rules contained in the Treaties, in particular to the rules on competition, in so far as the application of such rules does not obstruct the performance, in law or in fact, of the particular tasks assigned to them. The development of trade must not be affected to such an extent as would be contrary to the interests of the Union. (http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:12008E106&from=EN)*

These regulations and several ECJ decisions have not managed to achieve unequivocal agreement on social housing policies and practices in the EU (see also ECJ on Altmark Trans GmbH 2003). In the Netherlands, institutional free market investors complained to the European Commission in 2009 about the practice of the Dutch non-profit social housing developers (Wocos) with regard to distorting competition. Because there were clear income limits defined for people who qualify as tenants in a social housing project of the Wocos, the European Commission ruled that Dutch social housing funds had to be redirected, including to other developers, to guarantee a fairer market. The liberal-right wing government at that time in charge complied with the ruling and as a consequence an income limit of 33,000€/ per annum per household was implemented. This led to the exclusion of 650,000 middle-income households which formerly had been elgible for the housing projects (Elsinga/Lind 2012). Some experts considered this a severe shift of paradigm for the traditionally broadly structured social housing policies of the Netherlands (Streimelweger 2014). The long lasting mixture of living quarters had no more legal basis and all of a sudden the middle-income households were redirected to the private housing market if they looked for a new home. The association of the Wocos (AEDES) and CECODHAS (the European network for the promotion of decent housing for all) submitted an action to the ECJ, criticising the transgression of competences of the EU authorities and the breach of the subsidiarity principle. The verdict is still pending. (http://www.housingeurope.eu/resource-487/european-court-objection-housing-associations-to-sgei-decision-manifestly-unfounded)
A contrasting case took place in France in 2012 when the French association of home owners complained that the French government and the system of residential construction distorted competition in the housing sector. The European Commission requested a statement from the French government. The social-democratic government rejected the complaint and the intervention in national affairs. Unlike in the Dutch case, however, income limits are clearly defined for those entitled to social housing (Streimelweger 2014). The incident, so far, remains unresolved. But a similar case in Sweden led to the abolition of the non-profit status of social housing projects. The European Property Federation had filed a complaint to the European Commission, arguing that the rents were decreased artificially by this practice, and thus infringed European competition law. The conservative Swedish government decided to react to this and changed the housing policy towards more market liberalization.

3.3. Regulating the social housing market after the real estate bubble and credit crunch

The economic crisis and real estate bubble of 2008 made clear even to liberal market economic institutions such as the OECD, IMF and EU policy makers that the housing market

is a crucial indicator for the macro-economic performance of a nation or even a larger region. The monitoring of the housing market is practiced with regard to the economic policy coordination of the Member States (European Semester) and its tool (Macro-economic Imbalance Procedure, MIP). This is supposed to avoid structural mis-performances. The so called Alert Mechanism Report of the European Commission is a set of macro-economic indicators (scoreboard) designed to identify dangerous developments that could lead into the next major crisis. Depending on the weight of the imbalances identified the European Commission makes preventive policy recommendations of demands the Member States to take corrective measures (http://ec.europa.eu/economy_finance/economic_governance/ macroeconomic_imbalance_procedure/index_en.htm).

Since the housing market is tied to private household debts and price increases on the real estate market it can be interpreted as a measure for a state's macro-economic performance and financial resilience in the face of an economic crisis. But even though there are new monitoring instruments, this does not mean that EU macro-economic policy has changed since the last property bubble, even if the traditional "homeownership and his (the owner's) debt financing" (EC, 2013) towards more affordable housing has been recommended. Some of the EU policy recommendations such as reform of the housing system (as in the UK), a reduction in fiscal incentives for mortgage-based finance instruments as in Denmark, Sweden and the Netherlands, and a support for rental housing as for Spain, do not call the established standard housing policies into question. The key message of the latest recommendations is: less volatility of the real estate market for housing (EC 2014a). The overall policy direction from EU authorities and OECD experts is to reduce social housing in general and promote an unregulated free housing market.

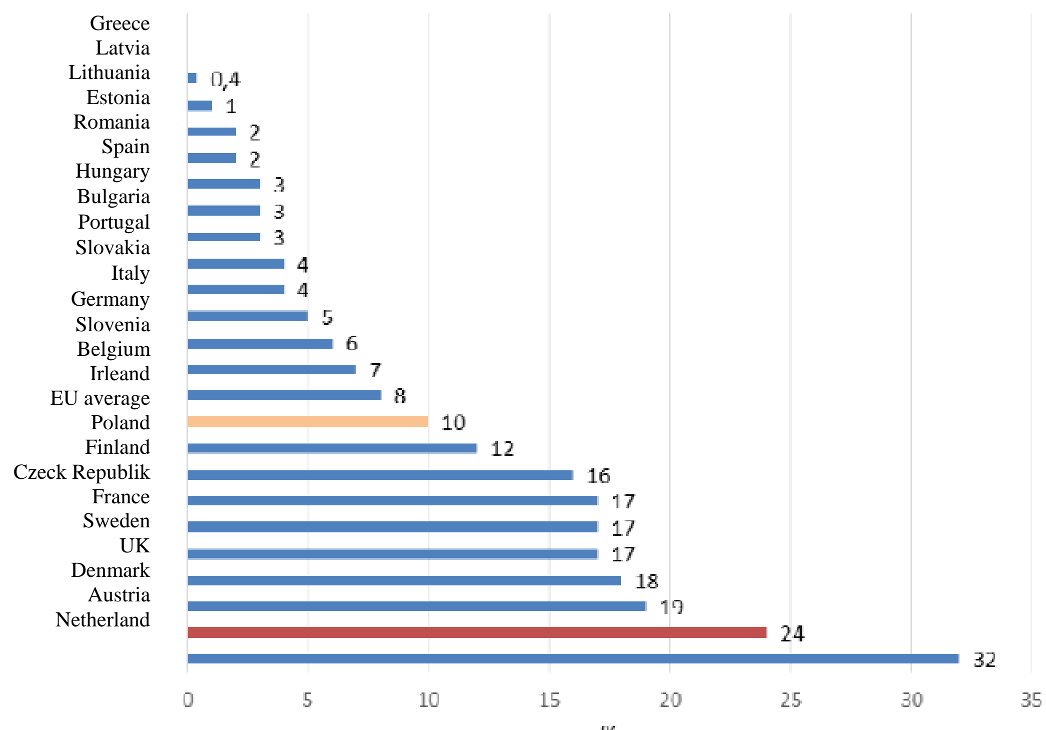
> *The European Union has set up a yearly cycle of economic policy coordination called the European Semester. Each year, the Commission undertakes a detailed analysis of EU Member States' plans of budgetary, macroeconomic and structural reforms and provides them with country-specific recommendations for the next 12-18 months. These recommendations also contribute to the objectives of the EU's long-term strategy for jobs and growth, the Europe 2020 strategy, which is implemented and monitored in the context of the European Semester. http://ec.europa.eu/europe2020/making-it-happen/index_en.htm*

Since its introduction in 2010 the European Semester governance process has increasingly criticized social housing policies in some Member States. The last year's report for 2015 gives country specific recommendations (CSR) for 16 Member States and has also monitored the reactions to earlier recommendations in the field (http://ec.europa.eu/europe2020/making-it-happen/country-specific-recommendations/index_en.htm). Housing Europe it its latest annual report of 2015 states that the recommendations to a large degree are over-simplistic, calling for market liberalization instead of using housing policy and funding as an instrument of counter-cyclical stabilization. (Housing Europe 2015, 95)

3.4. Dual system vs. unitary system in EU housing policies

Kemeny (1995) classified the role of social housing sectors in different countries with regard to the market-driven housing sector in such countries as dualist vs. integrated (or unitary) rented housing. He pointed out the disadvantages of the dualist housing regime where social housing is provided only for the very poor. By contrast, the unitary housing regime provides social and/or affordable housing also for the majority of the middle class and strongly

regulates the free housing market. Whereas the unitary regime promotes equality and a redistribution of wealth (although to a limited degree), the liberal-market regime favours equal opportunity of the individual in a widely unregulated economy. But there are mixed variations, too. Though the Austrian model tends more toward the unitary than toward the dualist regime, it does contain corporatist elements and has sought compromise between social-democratic, Christian-social and liberal-conservative approaches. As a result, there is a broad social consensus that household expenditure for living quarters should be decent, that strong concentration of low-income households in poor quarters of cities needs to be avoided and that precarious households at the poverty level need public support.
At the EU level and in many Member States the debate is often polarized as to whether the state should intervene on the demand side or on the supply side. However, empirical data from Austria show clearly that policies on the supply side are very successful.



Graph1: Social Housing in EU MS as % of total housing, source: CECODAS 2015

Countries with a large share of social housing that is open not only to the most marginalized but also to the middle class – France (16%), the Netherlands (32%), Sweden (17%), Denmark (19%) and Austria (24%) – have based their social policies on this pillar in order to maintain a strong welfare state (see graph below). This practice contrasts with the EU Commission's preference for a residual social housing model. Again, this discussion highlights the two already-mentioned opposite housing policies of the social sector – and thereby also the overall housing policies of a country – topics that are not new to the development of the post-WW II period.
We find the dual system foremost in Spain, Ireland and Great Britain aimed at providing affordable housing to low-income households. However, in those countries housing policy priority is to support housing property as part of private asset building/creation, incl. lower and middle income households and to compensate the low level of social benefits.

In a recent comparison, Scanlon, Ferández Arrigoitia and Whitehead (2015) state that even in countries traditionally pursuing a universalist social housing policy such as the Netherlands or France, "the private rented sector remains the main source of accommodation for non-priority groups" (7). They point out that priority groups are generally very low-income households, households with children or single mothers. Migrants however do not belong to this group. They have to turn to the private market of usually poor quality dwellings in inaccessible underprivileged locations. Even so, the fact that in most Member States rents for social housing are lower than for private dwellings does not mean that all pour households are able to afford such rents.

The neo-liberal turn that has prevailed since the crisis leads many governments to press for a more self-reliance and income-related subsidies to support poor households. However, those tenants who had already been provided with a social dwelling usually can remain there for their life-time. This is a common feature across many EU Member States. Even if over time the income increases or family size changes, tenure remains. Legal provisions for increasing rents when household income increases can rarely be applied because these actions are difficult to enforce and would have a negative effect on the social mixture of a social housing district. England's policy, however, is an exemption as the legislation allows for "probationary tenancies". This means that continued occupancy is granted only if tenants keep meeting all terms of conditions. As a consequence, not meeting such terms leads to an increase in rent or households occupying too big a space needing to move (Scanlon et al. 2015:7).

Last but not least, mention should be made of the trend whereby the most vulnerable households often reside in the private rented sector because they are not entitled to social support, do not understand the language and are thus excluded from the relevant information and services, or consist of large families that do not fit in small social housing dwellings. The most vulnerable comprise poor single households, retired poor people, people with illegal status and informal workers, and asylum seekers.

3.5. Precarious housing situation continues in all EU Member States

Social housing stock is a significant share of overall housing stock in Member States such as Austria, France, Denmark, Sweden and the Netherlands, but declining in general in the EU. In the same vein, government subsidies for investments into social housing and refurbishment has also declined, in part due to the neo-liberal credo of the free market, in part due to austerity measures after the financial crisis of 2008. Scanlon et al. (2015) point out that "Denmark and France stand out as having maintained investment through continued subsidy. At the other extreme, in both Sweden and the Netherlands, housing associations and corporations make a net contribution to the national coffers so new investments must be funded from providers' own equity." (pp. 9-10) At the same time, however, there is an increasing demand for social housing throughout the EU Member States (even before the refugee crisis) and waiting lists are getting longer (see below). In the same vein, it becomes increasingly difficult for mainstream households to finance homes on the private market at affordable costs.

"The state of housing in the EU hasn't gotten much better", states Marc Calon, Housing Europe President in the latest Report of "Housing Europe" (2015, p. 8). In this report, experts see demographic changes, their impact on health services, and continuous urbanization as

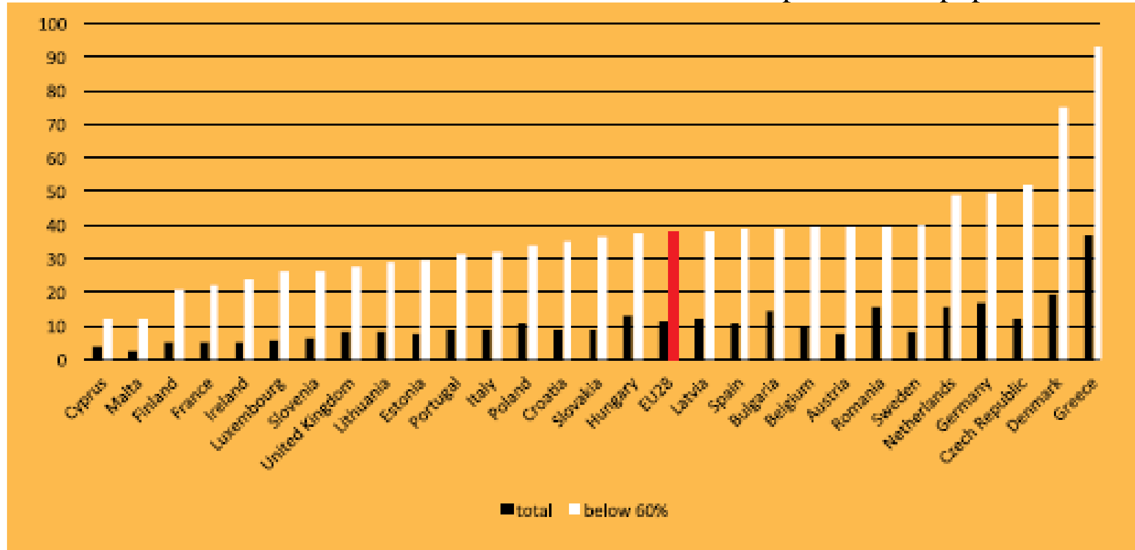
major challenges when dealing with low income household policies. Overall, EU housing policies have favoured the main stream rather than certain marginal groups and have not responded to the diversity of the people and households where it exists, says the report (10).
Prices for housing have been declining in most countries that suffered from the financial crisis, such as Greece, Cyprus, and also Slovenia. Only in Ireland, are house prices on the rise again. In countries not hit so hard by the crisis such as Denmark and Germany, the price slump has been recovering well. In Estonia and Lithuania the situation is similar. So in most EU Member States we actually are witnessing increasing housing prices, which does not so much contribute to the construction of affordable homes, as to the need for more homes in general. It is also worth to taking a look at the mortgage development over the last years which indicates in the EU as a whole families have been less willing or less able to take on mortgages and the rate given by the European Mortgage Federation indicates that gross residential lending in the EU27 in 2012 stood was remained at the level of 2007, that is 45.8%. Within the EU, however, the numbers vary considerably. The figures coincide with the trend that less households in the EU15 can afford to buy a home on their own and would rather rent a place. In this context, another important fact to consider is the cost of housing as part of average income. EU SILC data from 2013 show that housing costs accounted for 22.2% of disposable income for the total population, and about 41% for those at risk of poverty! The countries with the highest percentage are: Greece, Denmark, the Netherlands, Germany, Romania, the Czech Republic and Sweden. For Austrian households, the share is higher than EU average for those with an income below 60% of the national median but below average for the total Austrian population.
Also alarming is the decrease in new social housing dwellings in most EU countries, including the UK, the Netherlands, Austria, Italy, Denmark, Ireland, and Spain. The exception in the period of 2009 to 2012 is France where 116,000 HLM (French social housing units) were constructed.
Similarly, the number of people on the waiting lists for social housing has increased as we see for example in Table 1. Shortage of housing, and especially social housing, is more precarious in metropolitan areas that grow much faster and larger – both demographically and economically – than other regions in Europe. A case in point is the City of London with the highest deficiency in the UK, notably with 53,000 new homes required every year but only about half of that number being built annually between 2001 and 2011. The cities of Amsterdam, Utrecht and The Hague in the Netherlands expect a need for 300,000 additional new homes by 2020. And in the Swedish cities of Stockholm, Göteborg and Uppsala there is already a shortage of 156,000 dwellings. Also in German metropolitan areas around Munich and Hamburg there is a high pressure on housing prices and rents, with Berlin and Frankfurt following suit. (Housing Europe, p. 20)

Table 1: Number of people on the waiting lists for social housing in various EU Member States

Belgium	from 140,000 in 2008 to 186,000 in 2012
France	from 1.2 million in 2010 to 1.7 million in 2012
Ireland	from 56,000 in 2008 to 98,000 in 2010, then decreased to 90,000 in 2012
Italy	600,000 in 2008 to 650,000 in 2012
UK/Wales	90,000 in 2012
UK/England	1.6 million in 2012
UK/Northern Ireland	41,000
UK/Scotland	185,000
Estonia	from 26,000 in 2007 to 96,000 in 2011 (number of applications for public assistance with housing expenses)

(Housing Europe 2015, p. 16)

In the context of financing housing we should not forget to mention the debt linked to housing. The burden on mortgage indebtedness combined with the financial and housing crisis and subsequent austerity measures in some countries resulted in private bankruptcies and home foreclosures. Eventually, in some countries policy measures were implemented to prevent banks from foreclosing on primary residences, notably in Portugal, Greece and Ireland. Not so in Spain, however, where foreclosures were dramatic and resulted in strong social and media protests – even leading to a shift in political power in the city of Barcelona. (Housing Europe, p. 16) The graph below shows the degree to which housing costs overburden those with income below 60% of median and as part of total population.



Graph 2: Housing costs overburden rate among total population and those with income below 60% of median equalized income (source: SILC, data referring to 2013, cited in Housing Europe 2015, p. 18)

3.6. Social housing policies in Austria - a model for other Member States?

The example of Austrian social housing policies as instruments of macro-economic regulation shows that it can function in a resilient way to encounter devastating events such as the real estate bubble and credit crunch. Similarly, Germany and Sweden were hardly affected by the credit crunch, both countries that have relatively strong social housing policies (Scanlon et al. 2015, 10). Also, Denmark and France have invested in social housing after the crisis in order to stimulate the economy, other than in the Netherlands and the UK where public investments suffered from an overall cut. As Scanlon et al. note: “Some countries have used these economic and financial pressures to introduce policies that had seemed politically unacceptable before the crisis – notably by limiting funding streams, while requiring social landlords to take on increasing responsibilities.” (10)

In Austria some two million people have access to more than 880,000 community dwellings. More than two thirds of these dwellings are provided by social housing enterprises (gemeinnützige Wohnungswirtschaft). These enterprises are manage almost 600,000 rental apartments, that is 18% if all housing in Austria, and is thus the most important property developer (Bauträger) in Austria. 6% are provided by communal property developers. Welfare oriented social housing policy accompanied by generous housing subsidies is not only oriented toward the very low income households but includes also major parts of the middle class. This policy leads to a genuine social mix of inhabitants and to a large degree prevents urban segregation. Experts see this kind of housing policy as an instrument for social stability and the prevention of real estate bubbles. EU countries in which the housing market is structured as it is in Austria were not affected by the property crisis as much as the other countries, e.g. Ireland or Spain, where social housing is only a very small sector and housing policy instead targets home ownership (Wieser 2012, p. 121; Kunnert/Baumgartner 2012, p. 44).

Social housing is also an instrument for compensating market failure because in the long run a free market cannot provide affordable housing for the low and middle income households. The state has to takes major responsibility for public provision (Daseinsvorsorge). (Korinek/Holoubeck 2008, p. 53)

Austrian social housing policy comprises several instruments that fulfil this task. The funding of objects (property rather than individuals) through low interest loans is the most common instrument. Annuity subsidies to property developers or private investors are also common. The effective use of such instruments is based on the Limited Profit Housing Act which provides for rent control for the duration of the dwelling (Bestandsdauer) and asset ‘locking’ (Vermögensbindung). In this way, the advantages of the subsidies cannot be skimmed off by private owners or investors, instead apartment seekers, tenants and their offspring benefit. In this regard Austrian social housing policy and instruments differ fundamentally from the practice of other EU countries which prefer market-driven housing finance.

Concerning types of investments, social housing policy in Austria also differs from that in most EU countries. Whereas most EU countries make use of market-oriented funding models directed toward the individual (subject), Austria implements object-related policies (investing in housing or non-profit-housing companies). The UK, Spain, Germany and some other countries implement individual subsidies and tax relief measures. In most of the former-socialist countries, in Spain and in Italy, demand-side subsidies are also provided at regional or community levels as part of a social housing finance policy and are usually more restricted (Scanlon et al. 2015, 10).

Despite its object-related policies, Austria such funds represent only a small share of GDP (0.9%) (Wieser et al. 2014: 30). This symbolises the efficiency of Austrian housing policies. At the same time the instruments are also used to manage housing production. Due to its high funding quotas housing policy serves as an important stimulus to the economy in times of crisis (Czerny/Weingärtler 2007).

The legal regulations foresee that profit made in support of governmental housing subsidies is reinvested in the housing economy, e.g. for new housing projects or refurbishments. The EU legal framework does not provide for such non-profit forms of housing organization of public service. The EU legal framework only knows market or state interventions. But Austria is not the only state easing this dichotomy. Community-oriented non-profit social housing exists also in the Netherlands and in France and can be regarded as part of a "third sector" between the state and the market (Bauer 2014: 288).

By international standards Austrian social housing policy is one of the most efficient (Amann 2014: 3). Though after the war, it started similarly to the developments in Germany, it has followed quite a separate way. Once the legal provisions for public housing in Germany ended in the 1980s, Austria became the last country in Europe to have such provision. Experts see this as one of the reasons why prosperity in Austria enjoys a very high level and its social cohesion is one of the strongest (Amann 2014: 3). There are hardly any segregated ghettos in Austrian cities compared to other European ones. Austrian housing policy is a typical example of consensus seeking as the guiding principle, post-war corporatism and -clientelism as well. Some experts call this an example of European style social market economy (Amann 2014: 3), others define it as a third path between free market and social market economics (Lennartz et al. 2012). However perceived, social housing policies and funding policies especially are difficult to compare internationally.

However, even the fair Austrian housing finance model experienced severe changes over recent years and is in part turning toward a more market oriented model, albeit to a much lower degree than most other countries. As Springler points out, the change started already in 1968 when a law reform for housing finance started to shift funds from object funding to subject funding, which means that public money funds more the individual tenant or home owner, e.g. by social benefits for housing or rent at the expense of investing into the construction of new (social) housing projects (Springler 2012; Czerny 1990:9). Another move toward market liberalisation is the change of competence between the federal state and the regional (states) with regard to housing budgets, starting in the early 1990s. The regional states in most cases preferred the subject funding which for the most part did not flow into social housing projects but into cooperatives that subsidise individual home ownership. What is more, a change of the law at the turn of this century ruled that the profits made from such investments need not necessarily be reinvested in future housing projects and so the regional states used this money to plug other financial holes. During the 1990s when no acute housing crisis was noticeable and demographic change projected the decreasing need for homes, neo-liberal economists saw no need to invest in social housing and in many regional states of Austria, such funds were reduced. As a consequence, housing in Austria became less and less affordable, especially for the low income quartile (Beer/Wagner 2012; Springler 2012).

In many Member States, the housing situation is becoming more and more precarious, especially in the cities. This does not mean that Austria is an ideal type or a model. Careful policies have to be put in place to cope with the challenges to come and maintain a fair level of equality. However, when looking at developments in the former Soviet countries which now belong to the EU, we see that the privatization of homes in the 1990s has had increasingly negative effects. Privatization meant turning towards the free market model, or

the dualist housing regime, thus transferring almost all responsibility for maintenance, etc. away from the state (where it formerly belonged) to the new individual owners. In Eastern European Member States we today have more than 90% of home ownership (Hungary, Romania, Bulgaria) and the responsibility for commonly used spaces, for housing management, for refurbishment, etc. remains unresolved (Mundt 2014). It took some ten years until housing policies in these countries changed again, out of sheer social need. Conditions were changed to move toward a more state-controlled social housing system and today funding is provided by residential construction funds and similar instruments. An exception is Poland, which has adapted a system similar to the French model, with elements of community-oriented social housing (Amann 2014:8).
Interestingly, in Eastern European countries, such concepts are called public-private partnerships because post-communist societies did not want to identify with community-orientation or with cooperatives. However, political action in these countries is more than overdue because the housing stock suffers from lack of investment, caused by the privatization movement. There are hardly any appropriate instruments for refurbishment and low income households, young people and migrants suffer most. (Amman 2014: 10) At the same time, prices for housing on the private and black market skyrocketed, privileging only the high-income segment and home ownership. Since this development often times outpaces stagnating salaries, the insufficient housing market in many larger cities is an inhibitor to economic growth.
The accession of the Eastern European countries to the EU brought about a couple of changes in order to make social housing policy in such countries more feasible: e.g. the Residential Construction Charta; services with the purpose of common interest were exempt from the strict competition clause on the basis of a common consultation process finalized in 2007; EFRE was opened up for financing social housing; in 2006 the European finance institutions started the Joint European Support for Sustainable Investment in City Areas (JESSICA), targeting cohesion policy toward residential living and urban development (Mitteilung der Kommission KOM (2007) 725; Verordnung 1080/2006 vom 5. Juli 2006; Entscheidung des Rates vom 6.10.2006 für über strategische Kohäsionsleitlinien der Gemeinschaft (2006/702/EG).
In this context social housing policies of some of the “old” Member States came into focus such as the Netherlands and Sweden. They were interpreted of being in conflict with EU competition law.

3.7. Reform of social housing at national level

On the policy side in some Member States several efforts have been taken to react to the increasing need for social housing either by installing new funding measures for construction programmes, giving subsidies to those in needs, or making the private housing sector available for social housing. Table 2 gives an insight into some exemplary national measures.

Table 2: Recent social housing policy efforts in EU Member States

Bulgaria	New pilot project for social housing for vulnerable and minority groups; Increasing the amount of housing benefits
Czech Republic	New social housing concept (under discussion), incl. temporary housing for emergency situations; provision by the municipality of social housing and affordable housing
Lithuania	New programme for subsidized housing; recent introduction of rent allowances
Slovakia	New state housing policy to strengthen and develop public rental sector
Portugal	New program for social rental market; programme to use empty homes owned by banks for social housing; taxation of empty homes*
Italy	New housing plan funding renovation of public social housing; regional funding to secure social housing supply; new social rental agencies as intermediary between private landlords and low-income households; tax incentives to landlords willing to charging moderate rents
Spain	New Housing State Plan 2013-2016 subsidizing public social rental housing; support to tenants with low income; new social rental agencies as intermediary between private landlords and low-income households; programme to use empty homes owned by banks for social housing; taxation of empty homes*
Luxemburg	Financial measures fostering the construction of affordable housing and supporting new rental housing through planned obligations; new social rental agencies as intermediary between private landlords and low-income households; tackling speculation on land price; introduction of rent subsidies, which in 2011 constituted the largest category of aid by local social offices
Netherlands	Establishment of an income ceiling; new levy on housing corporations leading to a decrease in production of new social dwellings
England	Provisions such as social rent, affordable rent, intermediate rent and affordable home ownership peaked in 2010/11 with 60,480 units and decreased to 42,870 after 2013/14
Belgium	Restructuring the social housing sector through merges of social housing providers; new social rental agencies as intermediary between private landlords and low-income households; taxation of empty homes*; tackling speculation on land price
Greece	As consequence of austerity measures, the only organisations providing housing support in form of allowances and guarantees on loans, OEK, was abolished in 2012; parliament adopted humanitarian crisis bill, incl. the temporary introduction of housing allowances and a minimum quota for free electricity for the poorest households
Ireland	6 year programme to supply 35,000 social housing units; reform of social housing delivery and management; programme to use empty homes owned by banks for social housing
Hungary	new social rental agencies as intermediary between private landlords and low-income households;
Malta	Programme to mobilize privately owned vacant homes for social housing by guaranteeing rent benefits to occupants
Latvia	Increasing the amount of housing benefits

* in some municipalities (Housing Europe 2015, pp. 23-24)

The Committee for Construction of the Austrian Parliament passed an act in December 2015 to stimulate the construction of affordable housing. This project brings together the Housing Construction Investment Bank (Wohnbauinvestitionsbank (WBIB)) with shareholders from other housing construction banks[24] with governmental liability up to 500 M. Euro, the housing construction of the regional states, and 700 M. Euro from the European Investment

[24] Österreichische Hotel- und Tourismusbank (ÖHT), s Wohnbaubank, Raiffeisen Bausparkasse

Bank. Within five years the amount to be invested in housing by this public-private partnership is estimated to be 5.7 B Euro with an estimated 20,000 jobs created. This new bank will be the platform for financing the housing construction policy of the Austrian government which aims to create some 68,000 new homes. (Der Standard 2016)

3.8. Alternative Financing Model: Taking Apartment Houses off the Property Market

This new investment bank is a classical instrument of public-private partnership for funding housing. An alternative model is presented by the German initiative 'Mietshäuser Syndikat' which recently also started to support projects in Austria and Spain. The Mietshäuser Syndikat (apartment-house syndicate) is a mix of crowd funding, LLC (limited liability company; German: GmbH) and solidarity-based economics. It was created out of a squatter's movement in the city of Freiburg in 1989. The credo of the Syndikat is to take formerly conventional apartment houses out of the real estate market through a shared common investment and to provide living space at a rent that is affordable and usually lower than the standard rent.

This unusual organisation has some 530 members, including112 house associations, and deposits of about 400,000 Euros. This amount is the Syndikat's capital stock to be earmarked for investment in individual housing projects. In recent years, the Syndikat has been offered more and more projects as this idea has become more and more popular at the same time as housing has become more and more expensive. Which projects are funded is decided in a co-decision process by all members. Once a house is purchased, adapted or renovated and the new tenants have moved in, it cannot be sold anymore. This is guaranteed by the legal construct as each individual housing project is a legal entity of which the Syndicate holds 50%. "The title of ownership to the respective property is not in the name of the house association, but in that of a limited liability company (LLC). This house LLC has exactly two partners, the house association on the one hand, and the Mietshäuser Syndikat as a kind of control or monitoring organization on the other: in certain matters—such as the sale of a house, conversion into condominiums, or similar access to the real estate assets—the Mietshäuser Syndikat has a voting right, namely, exactly one vote, the house association having the other. This ensures that a change in the status quo of such fundamental issues can only be decided with the consent of both partners: neither the house association, nor the Mietshäuser Syndikat can be outvoted."

Such an LLC is founded with a stock of 25,000€; 50% contributed by the Syndikat, the other 50% by the people of the new project. This is generally not enough of course to buy a spacious house and take it off the property market. But the LLC and the Syndikat can help to get loans from banks that are not entirely profit-oriented but want to engage in social investment. Additional capital can be generated via crowd funding from private persons who are not interested in profit-making in the first place either. They make 'direct loans'. "Direct loans are sums of money lent directly to the project – without a detour via a bank. They offer individuals and groups the opportunity for a sensible, socially-minded, ecologically worthwhile, and sustainable investment. To this end, the lender and the housing project conclude a loan agreement." Like loans, the deposits are repayable after the agreed period of notice and interests are paid up to a maximum of 1% p.a. Each of the housing associations that exist up to this date is also a member of the Syndikat. In order to acquire interests in new house projects, the Syndikat needs a corresponding number of new members.

A new project is commonly started by a group of people who want to share a home and have identified an empty house for sale or want to rescue it from demolition or gentrification. The vision is usually to create more than just another living space. The house is a common project to encounter the horrendous development of the private property market and to give something back to society, e.g. host inexpensive space for new entrepreneurs, social projects, homeless people, refugees, children's day care, etc. Projects are realized in urban and rural areas alike. Later ones are often attached to organic and self-sustainable farming. All the details about adaptation and commitment of the living and working space are subject to self-determination by all members on the basis of lengthy discussion and fair and transparent decision making processes.
Having the Syndikat as a partner in a newly started housing project not only helps to get loans. The Syndikat can also advice in financial, legal and renovation or adaptation matters. Individual members of the Syndikat provide this kind of support on a voluntary basis.
The idea of cooperative housing on a solidarity and self-organized basis is becoming more and more popular and publicly acknowledged. The Syndikat is involved in projects all over Germany and –as pointed out already – recently also in a few other European countries. In 2012, the Mietshäuser Syndikat was awarded the Klaus-Novy Prize for Innovation in Cooperative Building and Living, which is awarded every five years by the Spar- und Bauverein e.G. in Solingen, the second-largest housing cooperative in the state of North Rhine-Westphalia.
Recent efforts have been supported in the Austrian city of Linz where a new initiative called Habitat was started in 2013 with similar goals and approaches as the Mietshäuser Syndikat. Four projects have been supported so far.

3.8.1. Conclusions: Social Housing at a crossroads?

The high percentage of publicly funded social housing for most Member States was a phenomenon of the postwar era. Today, analysis of European housing policies focuses on three models: universalist, corporatist, dualist. In most Member States, priority is given to certain clientele, not necessarily to the most vulnerable, or the poorest; only from the 1970s and 1980s did the more vulnerable increasingly begin to seek to be accommodated in mainstream social housing. In subsequent years, "both demand- and supply-side factors, changing government priorities and the aging of the post-war stock meant that social housing in many countries became residual…" (Scanlon et al. 2015, 11). Prospects of demographic change, government cutbacks, and EU competition directives turned social housing policies in most Member States toward market liberalisation in the 1980s. Those Member States that have continued their traditional social housing policies (Austria, Denmark, France, the Netherlands, and to some degree Sweden) experienced restricted capacities to continue this path and show tendencies toward a more market-liberal model. The other countries saw a period of mass privatization 1980s and 1990s with generally less new investment in social housing. However, the role of social housing is expected to be significant in the future and new financing models from the public as well as from the private sector, including the Commons, are in an experimental stage or starting phase.

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4. Twin Value Theory as Reflected in Accounting, and Its Consequences for our Understanding of Capital

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Abstract

Concerned as it is with 'the theoretical foundation of social innovation in finance', this paper provides an opportunity to explore further the idea of capitalising capacities and the concept of 'open access credit', as defined in earlier TU Delft contributions to the CrESSI project. Elaborated from the descriptor, its argument is that young people and social innovators are not able to access capital as long as its allocation is determined by a dominant paradigm that champions short-termist profit maximising. The focus of the paper is therefore on the need to innovate precisely in this regard.

Under the headings of 'circulating capital'[25] and 'open access credit', each one arguably a concomitant of the other, it first reviews the prevailing financial orthodoxy of maximising shareholder value, before elaborating its concept of a twin theory of value *as reflected in accounting* when the latter is understood as an instrument of perception rather than power, or for merely reporting to tax authorities or investors. By way of revisiting our understanding of such categories as profit and surplus value[26], it introduces a second role for capital as the enabler of capacities (or capabilities, to use Amartya Sen's terminology). The nature and form of such capital is explored by reference to two CrESSI case studies on financing education and entrepreneur capital, the substance of which demonstrates the imminence of and potential for open access credit even if the term itself is not in current usage. The paper then provides implicit and explicit examples of circulating capital and open access credit, concluding with a discussion of them in the case of complementary currencies and social impact bonds, followed by an appendix on their relevance to modern financial literacy.

As regards orienting its research to the triple framework provided by Sen, Beckert and Mann, the main focus of the paper is on Sen's 'capabilities approach', which is central to the CrESSI project's original conception. To that end, Sen's capabilities concept has been matched to capitalising capacities. For Beckert, while the paper does not make explicit reference to his three co-evolving fields (*cognitive frameworks, institutions* and *social networks*), the 'logic' of its approach is to put the weight on cognitive reframing – its ideas about profit, for example – because such things cannot easily be rethought without at the same time bringing into question and even promoting changes in institutions and social networks. Or, in terms of such of Mann's lexicon as seems germane; changes in mainly ideological, political and economic 'powers'. All three are interactive, of course, but the main impetus is ideological or conceptual.

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[25] As distinct from preserving capital.
[26] Five related terms are used in this paper: profits, surplus, surplus value, excess capital, and superabundant liquidity. These terms can have different meanings depending on whether expressed as plain (lay) English, as meant in economics or as used in accounting. The writer has sought to keep these distinctions clear. Where this has not been successful, the reader is asked to bear them in mind.

That said, ideas about social change are arguably more real if born at the 'coal face' where social conditions, such as marginalisation of all kinds, are both immediate and of real concern to those subject to them. For this reason and because its chosen topics do not lend themselves to an easy partition between the two, it should be admitted that much of the paper is at once theoretical and empirical. Whatever one may think of it, the structure of accounting, for example, on which this paper is predicated, exists. Why or how come one can debate, but the structure itself is a given.

Introduction

> In the first fire-engines, a boy was constantly employed to open and shut alternately the communication between the boiler and the cylinder, according as the piston either ascended or descended. One of those boys, who loved to play with his companions, observed that, by tying a string from the handle of the valve which opened this communication, to another part of the machine, the valve would open and shut without his assistance, and leave him at liberty to divert himself with his play-fellows. One of the greatest improvements that has been made upon this machine, since it was first invented, was in this manner the discovery of a boy who wanted to save his own labour, instead of expend it.
>
> – Adam Smith, *The Wealth of Nations*, Book I, Chapter I.

Though it was not part of his intention, in this well-known passage Adam Smith illustrates what in this paper we call the twin theory of value. Although Smith argues that the wealth of a nation derives from the expenditure of labour by its people, in this passage he clearly, if inadvertently, contradicts himself. By using his wits, intelligence, ingenuity, 'nous' – call it what you will, in this paper we speak of 'capacities' – the boy is able to save labour.

Whereas we cannot produce goods or put out a fire without expending labour on or in the physical world, we can use our wits to make this labour go farther. Thus, there are two ways that value arises: through the *expenditure* of labour, but also through its *saving* (or obviating). More precisely, as Smith depicts, value is born in part by labouring on nature, transforming it in some way (whether directly or via machines), and in part by using our capacities to save or obviate it.

So it is that, as rehearsed more fully in *Linking Modern Finance to Social Innovation*[27], the argument can be made that value comes about through a combination of two variously combined aspects – labour applied to nature, and capacities as they organise labour. In producing something of value (whether a good or a service), we at one and the same time labour and use our capacities to direct that labour.

The twin sources of value can be seen in terms of a continuum, on the one end of which are economic activities that are labour-intensive and require little thought (digging a vegetable patch, for example). On the other are activities that require little labour and are almost wholly of the mind – e.g. having a hunch. What can be achieved by the different cases, their return or

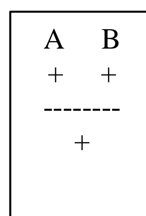
[27] *Embedding Social Innovation into an Account of the Co-evolution of Technology, Economy and Society - Linking Modern Finance to Social Innovation.* C.W.M. Naastepad and Christopher Houghton Budd, March 2015.

productivity, obviously ranges from very limited, at the one end, to limitless at the other – the difference, as remarked by Adam Smith, between one person making every part of a pin and the productivity consequent on the division of labour. Albeit unconsciously, we refer to this continuum when in usual parlance we speak of 'goods and services'. In terms of a twin theory of value, goods are, as it were, values with a great deal of nature in them (i.e. the *metal* of a fire engine), while services are values without natural or physical content (the *idea* of attaching a piece of string to a machine).

Neither end of the continuum can exist unto itself, however. In the direction of nature ('land' in economics) labour is *required* (and so expended), while in the direction of capacities ('capital') it is *obviated*, saved. Knowing this difference and getting the balance between the two poles right is the key to healthy conduct of modern economic life.

Furthermore, values do not come about merely from the side of provision. They must be needed by someone other than their provider. No matter how much labour has been expended (or saved) in its production, if something is not needed by a consumer it will have no value. Put another way, the value of something produced – whether a good or a service, a physical artefact or something wholly ephemeral like insurance – will rise until the moment when it is bought and paid for, at which point it loses its value. Production absent consumption makes no sense. It is of the very essence of economic life that all values produced must be used up, an axiom we ignore at our peril.

Although it is axiomatic that production presupposes consumption, it is important not to transpose these two *economic* categories into separate *classes* of people, such as capitalists and workers, for more fundamentally we are *all* both producers and consumers, combining the two dimensions through the universal medium of trade, exchange. Further, as Sketch 1 illustrates, in any transaction *both* parties aim to be better off (make a profit). Not only that, since in principle both parties make a gain, neither needs the surplus of the other. Hence, in thought at least, every trade gives rise to surplus value.



Sketch 1 : Image of exchange

But then the question arises: To whom should this surplus be credited? To whom does it belong? The answer given here is that it belongs to nobody in any private sense. Surplus value, of which today's 'excess capital'[28] or 'superabundant liquidity'[29] can be seen as an expression, is societal and so begs the question as to what best economic use to make of it

[28] See Adair Turner, former chair of London's Financial Services Authority, writing in *Prospect*, September 2009, No. 162. Lord Turner recently updated his views on the (unsolved) global financial crisis in *Between Debt and the Devil: Money, Credit, and Fixing Global Finance.* Princeton University Press, 2016.
[29] The term as used for example by Bain and Company (2010).

from which we all benefit. Our proposition is to link surplus value to its source, the stretching of labour by capacities – the mix of skills, talents, creativity and inventiveness without which economic life could not take place, or at least be fruitful, leaving our labour without purposeor direction. In a word, we propose that today's excess capital be used on the one hand to fund the *development* of new capacities by financing education, and on the other to further the *application* of capacities by providing entrepreneurs with 'entrepreneur capital'.

Both forms of capitalisation will engender new values, hence the central place given in this paper to the idea of capitalising capacities – a clear, if unexpected, example of what Amartya Sen's 'capabilities approach' means in regard to the agency and self-empowerment needed if young people are to be able to lead their own lives or social entrepreneurs are to undertake their projects out of their own initiative.

Per Sen's vocabulary, *capability* is one's ability and opportunity to achieve *functionings*, "the various things a person may value doing or being" (1999: 75), such as being educated, being able to participate effectively, having self-respect and dignity. These things are achieved through the *agency* of "act[ing] and bring[ing] about change" (1999: 5) through one's ability to pursue one's goals on a basis of self-determination, self-empowerment and autonomy. This one does through *conversion factors* that enable or prevent agency, either singly and internally (through the circumstances of one's own person, such as gender or age), or societally and externally through socio-economic conditions and institutions. (In Beckert's language, social networks and institutions.) It is for these reasons that funding or capitalising the development and application of capacities is treated here as a synonym for capabilities, with open access credit (elaborated below) understood as the main conversion factor, being both individual and societal, internal and external, on account of the changes it entails in regard to both our own behaviour and social policy.

If the pole of capacities is not seen distinct from the pole of land, if we do not see that in the direction of land labour is required, but that in the direction of capacities it is obviated, then, as noted earlier, we will try and predicate all value creation on labour, to which category or its representative, 'the workers', we will then always seek to credit any surplus. Or, if we are 'capitalists', we will credit surplus value to capital. In reality it belongs to neither – a point elaborated on in *6: Rethinking surplus value*.

As Sketch 1 illustrates, it is the *mutual* act of trading that gives rise to a surplus on *both* sides, surpluses that neither party needs, and that in fact go away from the enterprises in which they arise (see later Sketches 6 and 7). This would become obvious were shares, for example – the workhorse of modern investment – to be treated as a kind of loan, the term and rate of interest of which need not be fixed as with debt, but need not be whatever is left over, the residual value of a business, which is conventionally awarded to its investors.[30]

Interestingly, this appears to be an arrangement by convention, for there seems to be no extensive literature on the topic.[31] There is much on risk-reward ratios and the capital asset

[30] A topic explored more fully by the writer in *The Right On Corporation*, New Economy Publications, Canterbury 2004.
[31] But see, for example, Getzler, J. and Macnair, M. (2006) *The Firm as an Entity Before the Companies Acts*. Per *The New Palgrave Dictionary of Economics*, Second Edition, 2008, edited by Steven N. Durlauf and

pricing model (CAPM)[32] remains central to modern investment practices. However, such computations simply assume the residual value of a company belongs to its shareholders. One can perhaps understand an 'owner takes all' arrangement in circumstances of *unlimited* liability, where shareholders are also liable for all the debts of a company, but otherwise the idea seems to be a *fable covenu*, built into company and investment law, not by economic reasoning, but by reification of the interests of those whom such a convention favours – principally those with an investment in perpetuity, providing a return long after the investment, had it been a loan, has matured, and so giving an income to its beneficiaries merely because they own or inherited a piece of paper. As with maximising shareholder value (discussed below), the socio-economic validity of such investments (if not unearned income altogether!) is therefore a moot point, the more so if they inhibit or prevent the capitalising of capacities.

4.1. The theoretical foundation of social innovation in finance

So much for bald, even prescriptive, statements. The question is how does all this manifest in practical economic terms – that is, in the conduct of everyday 'business' – and what does it mean for economics and its particular description of economic reality? What does it say about the theoretical foundation of social innovation in finance? What is socially innovative about finance today?

Concerning perception

The answer to these questions depends in turn on another: How does one perceive so imperceptible a thing as value, as distinct from its manifestations in the form of goods or services? How does one make value both intellectually comprehensible and policy tractable?

The proposition of this paper is that this can best be done by what one can call 'deep accounting', that is to say, by using an equally sense-imperceptible medium or proxy, namely, the process and structure of accounting (compared to which, though also sense-imperceptible, maths and modelling are arguably lesser cousins).

One says 'sense-imperceptible', but this does not imply mystery. It refers to the five senses of smell, taste, touch, hearing and sight – none of which enable us to perceive value, price, ratio or indeed anything that one might call the 'substance' of economics. A triangle, for example, is sense-imperceptible. As are also market forces and Adam Smith's 'invisible hand' – a pair of ironies that have not deterred modern economics from claiming to be a rational science. In fact, of course, we apprehend such things through thinking. Whether rational or otherwise,

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Lawrence E. Blume, Mauro Boianovsky writes: Frederick Barnard Hawley (1843–1929) advanced the 'risk theory of profit' [according to which] profit is the reward entrepreneurs get to relieve the other productive factors from risk in competitive conditions. The normal rate of profit is determined by the expectation of profit that just covers the marginal entrepreneur's subjective valuation of risk.

[32] Devised by the likes of Treynor, Lintner and Sharpe in the 1960s, CAPM states that the return on a share of stock should be commensurate with the level of systematic risk associated with the company's stock (or its beta).

economics is wrought thought. The key is to recognise that clear or true thinking is self-evident, auto-empirical. Theoremic, rather than beholden to external data.

Avoiding dualism

The original descriptor for this task reads as follows:

> An important factor enabling entrepreneurs committed to social, ecological, and humane goals, is the way they attract and deploy financial capital. According to conventional economic theory, the allocation of capital should be determined by the maximization of returns that are private, financial, and short-term.[33] By contrast, social innovators can attract capital that is committed to goals that are focused on public goods, ecological or human benefits, and have a long-term perspective. For the latter, profitability can be a condition, but not a goal in itself. The key to the success of these social innovators is a novel perspective on capital allocation.
>
> Today, many developed countries face a problem not only of maintaining economic growth but also of addressing populations that are excluded from the mainstream economy and from the benefits of growth. Increasingly, lack of capital excludes individuals that are willing to develop their capabilities and be useful for society from employment or business opportunities. This problem is partly the result of an incomplete analysis of the role of capital allocation that continues to link capital only to physical production [with its consequent bias towards] maximization of economic growth.
>
> This task develops a perspective on capital that recognises two aspects: its role as the financier of physical production and its capacity to act as the enabler of human capabilities. This dual perspective on capital is grounded in a dual theory of value, which finds value in the satisfaction not only of material but also immaterial needs – particularly, in the human need to develop and deploy capabilities (e.g. Sen 2001, Nussbaum 2011). Once the link between capital and capabilities development is recognised, capital can flow more easily towards financing capabilities, and technology can be developed also for that purpose, rather than only for physical production.

Bearing in mind that it was written at the inception of the CrESSI project, which at the time of writing is now two years into its realisation, in general this descriptor holds up well. If it has a weakness it is the need for precision when using terms like ‘financial capital’, and the potential that imprecision in this regard creates for false opposition of ideas about modern finance. Opposing social, ecological and humane to private finance, for example, risks suggesting that private actors cannot have such goals, cannot be public-spirited in their dealings. Conversely, that public finance has none of the characteristics of profit maximisation.

The potential for dualism in this regard can be addressed and avoided, however, by tracking the, essentially monist, accounting version of economic events, as already hinted at and as developed further below. This necessarily entails revisiting some core concepts, especially profit, surplus value and capital, but also our understanding of growth in economics.

[33] It is worth noting here, however, that the short term is not in itself the problem, for some projects are necessarily such. The problem is being interested *only* in the short term coupled with constantly increasing gain, as when companies are pressed to make and distribute ‘improved’ returns on a quarterly basis.

Rethinking growth

To treat this topic in any substantial way is beyond the scope of this paper. Suffice it to say that in the natural world, growth does not occur without decay. The idea of growth for its own sake, growth without decay, on which much of modern economics rests, is beside reality, therefore, insofar as it refers to the physical economy – where everything from carrots to houses – comes into being then goes out of being, is created (as a consequence of ingenuity and skill) then deteriorates (because of nature).

The notion of economic growth needs to be nuanced so that in the direction of land it is never conceived without decay (that is to say, such growth has limits), but in the direction of capacities it is without limit in that there is no limit to knowledge or that, like the wheel, ideas once had never die. In other words, the notion of limitless growth needs to be confined only to the capacities aspect of economic life, a deeper and wider concept for what is often referred to today by such terms as the knowledge, or weightless economy, but that could equally well be described as the capabilities or capacities economy.

By arguing that today's abstract idea of economic growth ('growth, growth, growth') needs to be rethought in the one direction as limited and in the other as without limits, by distinguishing between the economics of goods and the economics of capacities, we challenge head-on the notion of maximising shareholder value whereby surplus value is allocated to shareholders, a practice rooted in 19th century financialism, born of the emancipation of the money markets from the goods market and giving rise to modern disconnected banking and finance. It is this process that makes the economy a servant of capital, and so reverses the traditional relationship whereby capital served the economy, culminating in Milton Friedman's well-known (2002) justification of maximising shareholder value: "Few trends could so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible."[34]

By definition, however, maximising shareholder value is the handmaiden or real world agency of abstract economic growth. Therefore it is also arguably the corollary if not the cause of marginalisation, especially credit marginalisation. It cannot be a coincidence for example, that the growth in size, scale and volume of today's financial markets runs alongside endemic debt levels and a widespread dearth of credit available for marginalised people.

For these reasons, whether directly or indirectly, we also argue that, insofar as marginalisation is the consequence of reduced opportunity, etc., it is linked in particular to credit-marginalisation. Investing in capacities, therefore, presents itself as the key to resolving the challenge of achieving economic growth *without* marginalisation.

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[34] Maximising shareholder value being an American import, for an informed and clear account of the rise of its dominance in Europe (via London) see Ch. 8*, City 1 Industry 0*, in *The City State – How the markets came to rule the world.* Richard Roberts and David Kynaston, Profile, London 2001.

4.2. Open access credit

As meant here, therefore, 'credit marginalisation' refers to today's constrained access to credit, especially on the part of young people and social entrepreneurs, who typically have the capacities but not the capital to carry out their projects. Our response to this problem is to make access to credit open, which is the social innovation in finance discussed in this paper, with social innovation understood in the sense given by the EC 2013 Policy Review[35], namely: "…new solutions that simultaneously meet a social need and lead to new or improved capabilities and relationships and better use of assets and resources." (Tepsie) Such social innovation "must be structurally aimed at meeting social need [and] must involve a new or significantly improved product, process, marketing method, and/or organisational model." (Selusi)

Fostering capacities

As outlined in earlier CrESSI papers[36], in terms of the above criteria open access credit is conceived as a way of 'making good' today's excess capital by using it to foster, unfold and facilitate the expression of human capacities and initiatives (especially on the part of young people and social entrepreneurs).[37]

The clue to this deeper meaning of capital is given by its etymology: *capitalis* or *caput*, the head. Not the head as skull or brain, but the head as the locus of such human capacities as intelligence, consciousness, and thinking – and therefore the origin of concepts, ideas, hunches. In this sense, in terms of economics, capital is a reflection of human capacities, whether they are innate or cultivated, gifts at birth or the result of education, or even simply born of being able to carry out one's hunch or realise a project.

As already noted, it is in this sense that open access credit gives meaning to Sen's capabilities approach by providing young people and social entrepreneurs with the kind and amount of capital they need to undertake their projects, based on the development and unfolding of their inherent or cultivated creativity, capacities and initiative, instead of real or peer-pressure

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[35] Social innovation research in the European Union *Approaches, findings and future directions*. Policy Review, European Commission B-1049 Brussels, 2013.

[36] *Concerning 'Social Finance' – Backgrounding piece for CrESSI project.* Christopher Houghton Budd and Ro Naastepad, March 2014; *Accounting, Economic and Sociological Considerations of Open Access Credit – Clarification of concepts for CrESSI project.* Christopher Houghton Budd and Ro Naastepad, March 2014; *Capital, Capacities and Capabilities*. Contribution to HDCA Panel, Athens, 2-5 September 2014, Christopher Houghton Budd.

[37] In passing, this can also be seen as a concrete response to the EU's policies and objectives regarding deprivation. See, for example, European Union, European Structural and Investment Funds, Guidance for the Development of Community Led Local Development Strategies, Version 2, March 2016. PP. 176-177 of the European Regional Development Fund Operational Programme includes activities that seek "to promote entrepreneurship and self-employment in deprived areas and targeted communities." PP. 78-80 of the European Social Fund Operational Programme, gives as one of its priorities the provision of "individual pathways to integration and re-entry into employment, for example through developing links between disadvantaged groups and local employers, the social economy, social enterprises and intermediaries able to provide information, advice and guidance on employment and self employment options."

collateral.[38] This entails a shift in conventional credit relationships inasmuch as, instead of them being set by lenders, it makes *borrowers* (and the success and profitability of their projects) the source of interest rates, maturity terms, rates of return, and so on, transferring the onus for monetary affairs from markets and 'authorities' to the individual users of capital – again, especially on the part of young people and social entrepreneurs.

Non-material economics

For open access credit to become operative, however, two other considerations are central. First, as already alluded to, the idea that today's excess capital is only excess because capital is narrowly defined in terms of the real economy, essentially the world of goods that meet material needs, requiring savings to finance investment in (physical) means of production. Second, the wider concept of capital advanced here adds to this 'traditional' notion the emancipatory dimension of capital as the counterpart to and enabler of human capacities.[39]

This is not to say anything new. Capital has always been emancipatory, as (Beckert 2011: 9) reminds us. But this emancipation has tended to have a particular twin context. Firstly, it has been confined to a relatively narrow group of capital owners. Secondly, as is historically understandable, it has always been associated with material production and material progress. In the last 200 years both these conditions have been modified considerably. As to the first, for better or worse, the ownership of capital has become greatly widened, although this cannot be said of our understanding of capital, still less about access to it. As to the second, with the increase in living standards consequent on modern productivity, our material needs have shrunk relative to our non-material needs, moving us up Maslow's (1943) pyramid.

As noted by Naastepad and Houghton Budd (2015) in their paper on *Aristotelian Economics and Modern Finance – A consideration of the true counterpart to today's financial markets*[40], "in the modern literature, the development of character (e.g. Grant 2011; Sandel 2012; MacIntyre 2007, 2009) and capacities or capabilities (Sen 2001, Nussbaum 2011) are highlighted as the highest human goal [such that the] real need of human beings whose material needs have been satisfied is the fulfilment of higher goals in life, particularly the development of higher capacities – including morality, creativity, and a self-actualization that includes responsibility for others (Hodgson 2012, Bowles 2011, Marglin 2011)."[41]

This change in recent decades echoes the concerns of the English economist, John Maynard Keynes (1930), who spoke of "the real values of life," namely, "to live wisely and agreeably

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[38] It would be too great a widening of our remit to examine also another key aspect of open access credit, the absence of collateral – neither real estate nor lending communities (as with such banks as Triodos, for example) or 'contingent renewal' (as used by Grameen Bank). Uncollateralised credit is not new; shares are that. As was 'lending to the person not the asset' in former banking tradition. Or when a gentleman's word was his bond. If there is collateral in open access credit, it is the regular review (self-audit) by an entrepreneur of his or her performance relative to the financial plan (see *Appendix: Concerning financial literacy*).
[39] See Houghton Budd, C. (2011) Finance at the Threshold – rethinking the real and financial economies. Gower, Farnham.
[40] Ch. 6. in C. Houghton Budd, C.W.M. Naastepad & C.P. van Beers (eds.), Report contrasting CrESSI's approach of Social Innovation with that of Neoclassical Economics. Deliverable 1.3 of the E.U. FP-7 project "Creating Economic Space for Social Innovation" (CrESSI).
[41] These points and passages of similar content and allusion link to ideas explored by the author and his TUDelft colleagues in other CrESSI papers.

and well." For Keynes, for example, the economic problem is to provide people with the goods required for their material needs so that they can accomplish what Aristotle called 'fine actions'.[42] In short, with their livelihood taken care of, human beings can become creative. But for this they need credit in their economy every bit as much as they need food in their mouths and a roof over their heads.

This is the problem to which open access credit is directly addressed. The increasing marginalisation of young people through growing worldwide endemic unemployment, for example, is part of a world in which capital promotes *material* productivity, rather than productivity, that is to say, creativity, *as such*.[43] It recognises the better fire engine but not the intelligence that authored its improvement. To move beyond the capital-preserving, past-oriented nature of modern finance, we need to switch to seeing capital as the harbinger of the future, understanding it afresh by predicating it on the development and realisation of the capabilities of young people and social entrepreneurs. In short, we need to see that the true purpose of finance is to enable individuals or communities to develop their own resources and to realise their own goals and potential – and to do so 'bottom up'. Compared to this, the Friedmanite notion, that the sole purpose of a business is to increase the wealth of investors, surely pales as a social goal.

As IMF Managing Director, Christine Lagarde, put it in her 2014 Amartya Sen Lecture on 'Empowerment'[44] at the London School of Economics: "To use Amartya Sen's language: If we want better capability, then we need better capacity ... Overall, we devote a quarter of our budget to capacity building ... [and to building] a modern financial sector, so that people can empower themselves through access to credit..."[45]

4.3. The meaning of 'capital'

Before proceeding, it is important to state our terms of reference as regards the word 'capital', a word with various meanings in finance and economics, most of which are biased towards the physical economy both as regards its form of capital and its analogical explanation. Taken at random from Wikipedia[46], the following extracts are typical:

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[42] For Keynes's link to Aristotle, see Robert Skidelsky (2009), and Robert Skidelsky and Edward Skidelsky (2012).

[43] In *The onrushing wave. In: Briefing: The future of Jobs* (18 January 2014), *The Economist* contrasted today's chronic youth unemployment to the effect of previous technological innovation, which always delivered more long-run employment, not less. In March 2016, *The Guardian* ran a series of articles on youth unemployment, which included the warning by ECB President, Mario Draghi, that "Youth unemployment is a tragedy and prevents people from playing a full and meaningful part in society. If every second young person is out of work – as is still the case in some countries in Europe – it seriously harms the economy, because people willing to work cannot work and skills are not developed. And it threatens social harmony. Unemployment can lead in the long run to increased social problems and ill health."

[44] Full text at: http://www.imf.org/external/np/speeches/2014/060614.htm.

[45] It is also worth noting that several of the papers submitted for the special issue of the HDCA journal on social innovation and the capabilities approach, which forms part of the CrESSI project, identify access (or rather lack of access) to credit as the key to authentic grassroots agency.

[46] We cite an influential online source because for many people today such sites are taken as authorities by millions of lay investors worldwide.

Adam Smith defines capital as "That part of a man's stock which he expects to afford him revenue is called his capital." Capital is derived from the Latin word 'caput' meaning head, as in 'head of cattle'.

This contrasts directly with our use, where *caput* is linked to capacities, to the human head and not to heads of cattle.

Capital goods, real capital, or capital assets are already-produced durable goods or any non-financial asset that is used in production of goods or services.

More simply described by economics as 'means of production', and by accounting as the list of assets on a balance sheet.

Financial capital is any economic resource measured in terms of money used by entrepreneurs and businesses to buy what they need to make their products or to provide their services to the sector of the economy upon which their operation is based, i.e. retail, corporate, investment banking, etc.

Discussed below, here the challenge is to ensure that such capital does not become disembedded, abstracted from the real economy and then set over against it.

Human capital is the stock of knowledge, habits, social and personality attributes, including creativity, embodied in the ability to perform labour so as to produce economic value. Alternatively, it is a collection of resources – all the knowledge, talents, skills, abilities, experience, intelligence, training, judgment, and wisdom possessed individually and collectively by individuals in a population. These resources are the total capacity of the people that represents a form of wealth which can be directed to accomplish the goals of the nation or state or a portion thereof.

This is what we mean by the capacities pole or the capabilities economy, except that one cannot stock creativity!

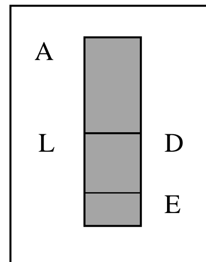
Natural capital is the world's stock of natural resources, which includes geology, soils, air, water and all living organisms. Natural capital assets provide people with a wide range of free goods and services, often called ecosystem services, which underpin our economy and society and some of which even make human life possible.

This can be seen as a match for nature or land in our terms.

Social capital is a form of economic and cultural capital in which social networks are central, transactions are marked by reciprocity, trust, and cooperation, and market agents produce goods and services not mainly for themselves, but for a common good.

In short, a description of how capital (and capitalists?) would behave were a twin value theory operational, because its main consequence would be the overcoming of the phenomenon of abstracted, financial capital.

General usage notwithstanding and whether directly or indirectly, for the most part in this paper 'capital' has the accounting sense of the liabilities side of a balance sheet (L) – see Sketch 2 – where it usually takes the form of Debt (D) (in German *Fremdkapital*) and Equity (E) or Own Capital (*Eigenkapital*).



Sketch 2 : Our meaning of 'capital'

Strictly speaking, when an enterprise receives a sum of capital, that amount is debited to Own Capital on the liabilities side and credited to Cash on the assets side. The entrepreneur or manager then reallocates it to other asset categories – Buildings, Equipment, Inventory, and so on, each one of which can be understood without the designation 'capital'. In this paper, the asset side is synonymous with 'means of production', but we never use capital to mean asset. (We also make a further distinction between *capital*, linked to the balance sheet, and *money*, linked here only to the trading of an enterprise, its provision of a good or service, and so not to its means of production.)
We are aware that our usage is at odds with most standard explanations. For example, *Investopedia* states[47]: "Capital itself does not exist until it is produced. Then, to create wealth, capital must be combined with labor, the work of individuals who exchange their time and skills for money." But for us this is a very moot statement. Is capital "produced" or does it arise? What is the difference between capital and wealth, the latter usually understood as an abundance of something, typically resources or possessions? And is it true that work amounts to "an exchange of time and skills for money"?

The accounts of self-employed people, for example, show that they do not derive income as a 'wage', an expense, but as a drawing down of capital. For self-employed people, the money paid to someone else, such as a secretary[48], will be an expense, but for themselves they first make a profit, which is then taxed, after which the balance is transferred to the Own Capital account on the balance sheet, from which their Drawings are deducted. Moreover, given that self-employed people have a direct interface with the tax office, they also have to compute and provide for any tax liabilities, putting the money to one side *pro tem*. Employed people do the same thing in fact, only they have a contract with their employers to deduct and remit tax on their behalf.[49] The default position, therefore, is that *none* of us lives from wages (selling time or skills in exchange for money); we *all* derive our income from the capital we have created. This self-evident truth of accounting is, however, obscured and distorted by the divisive nomenclature and institutional landscape associated with 'workers' and 'capitalists',

[47] http://www.investopedia.com/terms/c/capital.asp#ixzz43leydLtp, another an influential online source.
[48] Who likewise derives income not as a wage but as a deduction from capital.
[49] It would take us too far to enquire into how Pay-As-You-Earn came about, effectively ensuring cash flow for the Exchequer, but the point stands without this discussion.

'employees' and 'employers', the more so when such terms are hitched to ideological preferences and strategies.

Our particular use of the term capital has an immediate intended consequence, namely, to reinforce the view that, although the manner of doing so may vary going forwards and when compared to how it has been to date, capital should always be linked to real economic life, not abstracted or disassociated from it. Admittedly, in our times capital can be very attenuated as to what it represents – in this paper, capacities as distinct from physical means of production – but attenuated capital is not financial capital. In no sense, therefore, does our understanding of capital recognise a kind of capital that can exist regardless of its consequences for the real economy. This contrasts with any notion, such as 'financial capital', that suggests, embodies or reifies the abstraction of capital and its treatment as something outside the economy – as if it can have a life of its own.

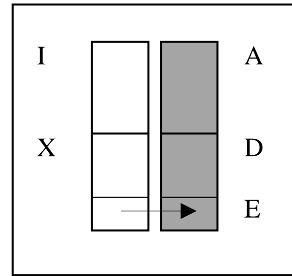
4.4. Profit as a social metric

This precision of vocabulary is necessary because unclear thinking in this realm – albeit often expressed as plausible economic theory – is one of the main reasons why the kind of capital needed by social entrepreneurs is not readily available. When, to repeat, Milton Friedman states that, "Few trends could so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible," the effect of his mantra is that, for him and all who accept his precept of maximising shareholder value, the whole purpose of business is to enable capital to abstract itself, such that the economy serves capital rather than capital serving the economy.

Whether Friedman's ideas represent rigorous theory or an argument of convenience for financialism is a topic well-rehearsed by Mosini (2011). She also shows how much modern financial theory glosses over the need for a more inclusive understanding and type of economics than that currently prevailing – a debate that goes back to the early 20th century work of John Neville Keynes and others.

It is only if we ignore this challenge or override it with the triumphant capitalism of recent decades that the principle of maximising shareholder value becomes the 'only game in town'. Accordingly, it is under such a paradigm that profit becomes the goal, not merely a condition, of economic activity, with the latter undertaken only in order to make a profit, in order in turn to increase the value of shareholders' investments.[50] Conversely, therefore, social innovation in finance, and open access to credit in particular, means that profit is a condition not the goal of economic activity, and that our horizons need to be other than merely short (and narrow).

[50] Practical reference is here always by way of the standard practice of modern corporations since it is they that give effect to and thus exemplify economic theory related to maximising shareholder value.



Sketch 3 : The logic and structure of accounting

As shown in Sketch 3, however, this is precisely the true logic and structure of accounting. Per accounting, 'profit' merely records that income (I) is greater than expense (X)[51], the 'result' (see arrow) then being added to the Equity (E) or Own Capital account on the balance sheet when the accounts are closed. If one assumes that the sales of an enterprise have been freely made by its customers, and that none of the expenses have been at the cost of the enterprise's environment, neither physical (e.g. nature) nor social (e.g. remuneration) – in other words, that there are no 'externalities' and that everyone working in or for it has been fairly and adequately remunerated – then profit can be seen and is perhaps best understood as a social metric. In this sense, profit measures the social validity of an enterprise as also that of its entrepreneur's contribution to society.

It is a different matter, however, when one asks to whom does profit belong. As already noted, according to standard economic theory, as also in the capital structure of conventional corporations, profit is assumed to belong to the external providers of capital, the shareholders, on the (possibly specious) grounds that those who risk their capital are entitled to all the rewards for doing so, so that to them belongs the residual value of a business. Accounting, however, implies no such social contract. 'Risk = reward' thinking may well provide an alibi for the maximising shareholder value principle that favours shareholders over all other stakeholders, but is this view anything other than a lifestyle choice derived from Darwin, rather than from the logic, structure and technique of accounting? It may prove important, therefore, as this paper endeavours to do, not to ascribe to economic dealings any moral ground other than that reflected in accounting as such.

To say this is not to argue for or against any particular ideology. Our aim is to demonstrate the ideological neutrality of accounting. When not used as a means of power or merely to report to investors or tax authorities, accounting acts as an instrument of perception, enabling us to see the inherent, other-oriented ethos of economic activity – namely, that to be an entrepreneur is to meet other people's needs for goods and services, just as, ideally at least, the role of investors is to meet the capital needs of entrepreneurs; what Amartya Sen would call the ethos of 'commitment'.[52] That is to say, in this paper we ask how else, other than in

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[51] As used here, 'income' and 'expense' covers all items that conventional accounting would so name, see any standard chart of accounts of list of nominal codes.

[52] Sen, A.K. 1977. "Rational Fools: A Critique of the Behavioral Foundations of Economic Theory," in *Philosophy and Public Affairs*. Vol. 6, no. 4, pp. 326-7; Sen, A.K. 1982. *Choice, Welfare and Measurement*. Oxford: Blackwell, p.69.
See also discussion in D1.3, Pt. 3, Task 1.5, Ch.7, *Commitment to social and ecological objectives: crucial in generating innovations for the marginalised?* in Houghton Budd, C., Naastepad, C.W.M. & van Beers, C. P.

terms of maximising shareholder value, can capital be allocated and what does accounting tell us in this regard?[53]

4.5. Some observations born of accounting

Providing the observational foundation of our twin value theory of finance, several key remarks can be made concerning accounting:

First, we should note that, whether in a for-profit or a not-for-profit organisation, a corporation or a cooperative, club or association, the logic of accounting is constant – when income exceeds expense, the difference or result is allocated to the Own Capital account on the balance sheet, becoming thereby internally generated capital.[54] The different treatment of this Own Capital – namely, whether it is distributed to the individual members of an organisation (as in so-called *for-profits*) or debarred from such distribution (as in *not-for-profits*) – is a taxation distinction, not an accounting one.

Second, and very importantly, albeit subject to the above-mentioned basic tax divide whereby if the profits are not privately distributed tax exemptions may be allowed, decision-making jurisdiction over the Own Capital account rests with those who run the business, not with those who invest in it. In other words, accounting does not have a view as to how internally generated capital (profit) should be allocated. That is decided by those responsible for the conduct of the business (i.e. the managers or entrepreneurs, not the shareholders). For example, before or even instead of paying a dividend, they may pay down debt, or acquire new means of production (assets) in order to expand the business.

Third, the standard construct is that of a conventional company, in terms of which surpluses are allocated to shareholders only, on the already critiqued grounds that the residual value of the company belongs to them and only to them. Based on 'one share one vote', this construct conflates pecuniary and voting rights and, taking majority shareholding principles as a given, avers that the more money one has invested in a business, the more control one is entitled to have over it. Even that one owns the business, although what one actually owns are the shares in the business, 'ownership of a company' being a misleading shorthand.
This ought to give a huge hint as to the need to revisit the rationale of majority shareholding with a view to transforming it by distinguishing between and even decoupling its pecuniary and voting dimensions. Instead, fourth, the historical response from the early 19th century onwards has been to argue for 'one man one vote', in order thereby to vest the power of capital with the workers rather than the capitalists.

(eds.) (2014) Report on institutions, social innovation & system dynamics from the perspective of the marginalised, Deliverable D1.1 of the EU FP7 project Creating Economic Space for Social Innovation (CRESSI).

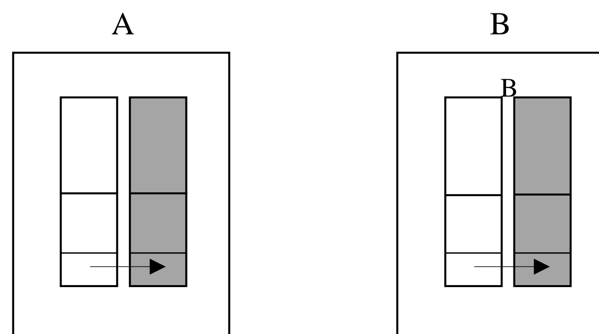
[53] In passing, it should be noted that, because we regard the true nature of economic activity as other- not self-serving, we do not think in terms of financial versus social, but in terms of financial and economic deals that can be either but need to be both.

[54] This is done via the closing entries, typically done quarterly or annually for investor and taxation reporting, but in principle done every time a transaction is booked.

And yet, strictly speaking, neither point 3 nor point 4 are born of the logic of accounting. The one simply allocates surplus in accordance with 'capitalist' ideology, a practice that begets the other, the very understandable 'socialist' response of cooperativism. By this road, however, we enter upon the seemingly permanent divide between Right and Left ideologies, although accounting itself knows of and therefore leads to no such thing. By this road, too, we come to think of the economy, not as humanity's commonwealth with capital as a kind of commons, but as a domain to be captured and possessed by one group at the expense of everyone else.

Born of accounting practice rather than theory, these remarks are not made in the manner of a hypothesis to be tested externally. We advance no explanation of why accounting is as it is. Instead, our aim is to describe the how and what of it, namely, a set of self-evident truths for which no 'why' is needed. Accounting is theoremic, on which basis, just as it regards profit as a neutral phenomenon, so accounting tells us an important story as regards value and extra or surplus value – a story already rehearsed pictorially in Sketch 1 and replicated below in Sketch 4 in terms of accounting.

As shown in the earlier icon of Sketch 3, in *any* set of accounts anywhere in the world – here, there and everywhere; then, now and in the future – the structure of accounting expects income to be greater than expenses (white boxes), and that the difference is transferred to the Own Capital account on the balance sheet (grey boxes). Sketch 4 then uses this icon heuristically to show that in every trade, both parties to it, A and B, experience an increase in value, which accretes to their respective balance sheets.[55]

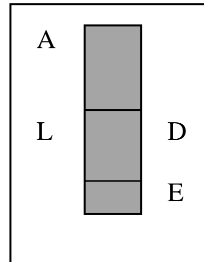


Sketch 4 : Exchange per accounting

One can go further. Repeating Sketch 2, Sketch 5 shows the starting balance sheet of any economic activity (whether for-profit or not-for-profit). It begins with the things needed to provide the proposed good or service (the assets, or active side of the balance sheet). When bought at the going rates, these determine the amount of capital needed on Day One, which is then provided classically through a mix of Debt and Equity. Thus, the liability side of a

[55] Of course, when income is less than expenses the capital is reduced, but it is important to note that in accounting this is not the default position, but an aberration. In social reality where a trade does *not* result in profitability on *both* sides there will be found to be some skewing of the content or context of the trade.

balance sheet initially comes about as nothing other than the financing of the means of production[56].



Sketch 5 : Starting balance sheet[57]

Strictly speaking, just as assets are used up in providing goods or services, so should capital be used up in order to reflect what is happening in socio-economic reality. This is in fact what happens: if the assets fall in value, the equity in a company falls in value also. Only we try to pretend otherwise. It is here that the notion of preserving capital rather than using it up sets us at odds with reality, leading ultimately to a so-called 'financial' version of values that is all too easily at variance with the real economy.

In reality, when capital is invested in a business, it is used up in buying the assets. These assets are then used up, in turn, in the creation of new values. The net revenue (income less expenses) from the provision of goods or services is then returned to those who invested the initial capital, as if *that* capital were still there and had grown. What is still there, of course, is the obligation to the initial investors. But it is by no means the same money that returns in greater quantity or volume. Again, the initial investment having long disappeared into the assets, we conflate or falsely connect the pecuniary and relational aspects, by using newly arisen values to honour old obligations.

Sketch 6 illustrates how a profitable enterprise (and the structure of accounting expects all enterprises should be profitable) does this, first (i) by refunding direct loans borrowed at specified interest rates and maturity terms (Debt), and then (ii) by 'rewarding' indirect loans, namely shares (Equity), where the rate of interest and term are unspecified, or, rather, specified by default as 'whatever is left over'.

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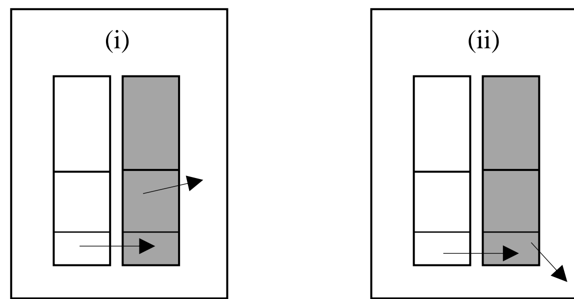
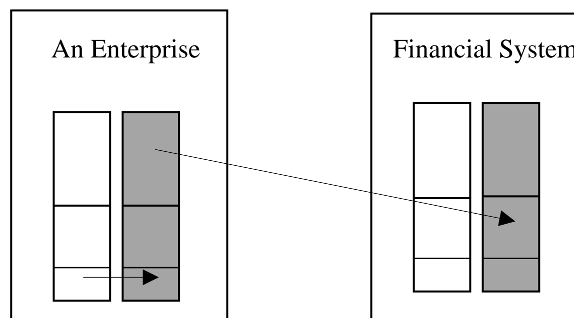
[56] Here 'means of production' has a wider meaning that that given to it by economics: machines, buildings, capital goods, etc. Those are the *things* needed to produce; but one also needs cash at the bank (liquidity), credit to extend credit to customers (receivables), and so on.
[57] The lexicon of continental accounting is different. More tellingly, it speaks of *active* and *passive*, instead of the Western terms of assets (things *I* have) and liabilities (things *I* owe), biased as they are towards self-interest.



Sketch 6 : The use of profits to refund (i) Debt and (ii) Equity

Sketch 7 shows that if this process continues, internally generated capital (profit), now no longer needed to displace externally provided capital, becomes capital *in excess of* that needed to finance the business's own means of production (assets). Via the financial system, this extra capital is then lent out to the rest of the economy, becoming an asset to itself and a liability for the rest of the economy.



Sketch 7 : The problem of excess capital

Legally and juridically, of course, it is possible and commonly done to describe this extra value or excess capital as belonging to the investors, but *economically* it has passed into the hands of other entrepreneurs, albeit via financial agencies. Again, the assumption to be questioned here is that shareholders are entitled to the residual value of a company. If, for example, the amount due to shareholders were to be capped both in terms of dividend and maturity, then some of the excess could be retained for the financing of education or used as 'entrepreneur capital', freeing entrepreneurs to take initiative. (How this would happen concretely is discussed later in *Section 8: Two forms of capitalising capacities – financing education and entrepreneur capital*.)

In an open economy – that is, in a situation where the boundaries of the entire economy are as yet unknown and where there is more than one economy – this process is difficult to perceive. But in a single closed economy, such as that of the world as a whole since 2008, it will become obvious that, just as per entity, so per sector, and then for the economy as a whole, the need for financing of the means of production will become sated, but the process of value creation will not stop. In Switzerland for example, pension funds have 'stocked'

seven times more capital than the real economy could absorb.[58] This means that the excess has to be used up, as it were, not preserved or stocked, not lent back to the real economy whence it came, but which has no need for and so cannot afford to borrow it.

4.6. Re-imagining surplus value

In the above ways accounting shows that any extra or surplus value is (a) societal and (b) has to be used up in ways other than those linked to physical production. As already stated (but not yet elaborated on), this means that excess capital should not be abstracted into financial markets, but used up by way of financing education and providing entrepreneur capital in order, respectively, to fund the genesis and application of capacities. Such an approach reflects that it is to capacities that the surplus owes its origin because that is what stretches, obviates, saves labour.

From this it is clear that one should be careful how one envisages the emergence of value and surplus value. In the related Sketches 1 and 4, we have shown how each and every exchange involves two parties, both of whom are 'better off' after the exchange and because of it. If this were not their intent, at least, no exchange would ever take place. This is true of every type of exchange, from the most 'real' (carrots for cabbages) to the most 'financial' (interest rate swaps). The irony, paradox, riddle, mystery – call it what you will – is that through exchange *both* parties are better off, not only one of them, and not the one at the expense of the other. Sketch 8, for example, is not a true representation of economic reality. Of course, there may be cheating, or deals which are not successful, and so on, but in principle those are aberrations and not what the logic of accounting normally expects.

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Sketch 8 : Untrue image of exchange

Understanding the true, *social* nature of finance, therefore, depends on comprehending how it is that exchange is not a static or barter phenomenon, implying no progress. On the contrary, trade is the motor of progress. Moreover, the fact that it gives rise to surplus value is vital because it shows that, while *proximate* increases in value can belong to or be used by individual parties to any trade, surplus value is societal – *overall*, it belongs to us all. Again, the question is in what way?

Because, *per* our opening passage from Adam Smith, we do not ascribe all value to labour, we do not allocate surplus value to 'the workers'. But since we also do not ascribe value only to capital, we do not allocate it to 'capitalists' either. Instead, realising that from an accounting, and indeed a socio-economic, point of view, value creation is a joint venture involving not only the workers in an enterprise and those who finance it, but its customers

[58] Swiss Confederation, Office for Statistics, Social Security Report 554-1100, Neuchatel 2013.

and suppliers, we seek a more general, even universal, source and therefore destination for surplus value, namely, the class-less category of human capacities.

In principle, it is only when we refuse to use up surplus value in this way that financial markets come into being of a kind that exist at the expense of rather than in service to the real economy. In short, therefore, the jeopardy that the financial economy has placed the real economy in is the result of not recognising this problem (with its associated processes, dynamics and consequences).

To say this is not to attack financial markets *per se*, or to see them as evil, or as the instrument of a malign elite. It is to point to the short-sightedness or myopia of much of our economic thinking. Leave out the role of human capacities or capabilities in creating value, especially leave it out at a time in history when most value has no other genesis, and the true economic origin and purpose, source and destination of today's excess capital will be misunderstood and so become seen as something that needs to preserve, meaning increase, itself rather than as something to be lost into the creation of new values.[59]

Some years back, City of London economist, Roger Bootle[60], described today's conditions as those of increasingly 'weightless economics', characterised by continually *increasing* returns, but to consumers rather than producers.[61] In this 'new economy' invention has overtaken manufacture, with the consequence that physical production is 'stretched' by technology so that we can achieve more with less effort, meaning also less cost. Consider Beethoven: he no longer receives royalties, but every time we enjoy his music we are (or consider ourselves to be) better off.

Of similar vintage, but by no means passé, is the idea of an 'experience economy', a term first coined in 1998 by B. Joseph Pine II and James H. Gilmore in their book of that title. Likewise, the 'transformation economy'. In both cases, people pay for the experience they have or undergo, not the thing they bought. One could also, of course, place the 'educational economy' in the same genre. Likewise, for many, the importance of brands.

4.7. A second role for capital

The above discussion about surplus value has been necessary in order to take further our argument concerning social innovation in finance. Without such an explanation of surplus value we have no real way of dealing with today's excess of capital – other than to continue the 200-year old, but increasingly stale, debate over its ownership, all the while that the financial economy continues to hold the real economy to ransom to an ever-increasing extent.

By thinking in terms of two poles to economic life, nature and capacities, with labour as their intermediary, our thought is to identify a counterpart to the ever-growing amount of capital

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[59] The money is not of course lost in any way. It simply moves round the economic circuit, passing from one trader to the next.
[60] Bootle (2000) Speaking to the Economic Research Council, London, 8 December 1999.
[61] For a more recent look at this theme, see http://www.global-economic-symposium.org/knowledgebase/the-future-of-jobs/virtual-library/labor2019s-digital-displacement/

that is in excess of the needs of material production – even though many of those needs are artificially stimulated by planned obsolescence, etc.

If, per Bootle, Pine, Gilmore, et al., one scales up Adam Smith's simple (real life) observation of the boy and his string, it is not difficult to see that as a source of value the capacities or immaterial pole far outstrips the natural or material pole in our times. The problem, however, is not this out-stripping, but the attempt to predicate today's attenuated capital on the physical or material economy, the economy of making things – from which economy it has in fact escaped, as it were. Today, the non-physical economy (leisure, financial products, experience, knowledge) is far greater than the material one. This is especially so if one has regard to the initiatives or development that individuals or whole peoples would take but cannot for want of the right type and amount of capital, capital that needs to be given or invested at risk, not lent by financial markets on the basis of an assured return.

4.8. Two forms of capitalising capacities – financing education and entrepreneur capital

The question arises, therefore, what form capital would take were it linked to capacities. This has been indicated in the two TUDelft case studies on *The Financing of Generalised Education*[62] and on *Entrepreneur Capital*[63].

The Financing of Generalised Education argues that the logic of the history of the financing of the generalisation of education leads to the idea of funding education through taxation-derived grants, rather than borrowings such as student loans. Space does not permit us to rehearse this argument here to any depth, but, quite apart from whether one accepts or agrees with it, it is instructive to look at how grants are accounted for – see Sketch 9.

The grantor is typically a foundation or public body of some kind, and the grantee a not-for-profit. The grant is therefore a transfer of capital from grantor to grantee, with the latter debarred from distributing its Own Capital to private parties. In accounting terms, the grantor reduces his Own Capital (see changing amounts in grey boxes) and therefore Cash (see changing amounts in white boxes) in favour of the grantee, for whom it becomes an increase in Own Capital and so an increase in Cash.

[62] Financial and monetary innovations for overcoming social exclusion – The financing of generalised education (as instanced in the Netherlands and England). Christopher Houghton Budd, C.W.M. (Ro) Naastepad, Martijn Jeroen van der Linden, March 2015.
[63] Entrepreneur Capital. Individual Case Study CrESSI WP 2, Deliverable 2.2, July 2015.

Grantor

1000 | 500 | 500
1000 | (500) | 500

Grantee

0 | 500 | 500
0 | 500 | 500

Sketch 9 : Accounting for capital transfers

The decision then has to be made what to do with the cash, whether to acquire a different asset or to expend it. If the grantee is a school, for example, the need for assets is minimal, but salaries may be as much as 85% of the operating budget. So most of the cash will be paid out as salaries.

In short, if excess capital is transferred to an educational organisation (or to teachers in general) then it will mainly be spent on salaries. The benefit associated with this cost will be society as a whole, because of the positive 'effects' of educated children. In other words, one form that excess capital can take is for it to be given away, used up in paying teachers.[64] But this means the capital has to move on, even 'disappear' – not be 'stocked' or preserved – so that *in time* new values can arise as a result of the teachers' work, i.e. the children's education. The important thing is to recognise that in this field cost-benefit has to be understood generationally and societally, not, as in today's narrowly-understood physical economy, in terms of proximate net gain.[65]

In *Entrepreneur Capital* the example was given of the need for a kind of capital that would enable social entrepreneurs to fund their activities as they, not their capital-providers, saw fit. Here, the accounting of capital transfers is different in that, whereas in the financing of education the capital is mainly spent away, with 'entrepreneur capital' the capital will go to Cash and the entrepreneur will decide whether it is best-used to finance means of production or to pay salaries, for example. It is this decision that gives rise to the terms and maturity of the entrepreneur's borrowings, when these are no longer determined by the lender.

Again, this challenges head-on the notion, habit and practice of preserving capital at all costs, regardless of what such financial economics does to the real economy. But so be it. That is the new paradigm needed – to forgo preservation of capital in favour of circulating capital via the medium of financing the development and application of capacities.

[64] Or students, for those who aver that they should 'buy' the education of their choice and so be the source of teachers' income.
[65] The rising incidence of spend-out foundations is evidence of this concept. See, for example, http://www.fastcoexist.com/3032717/an-unconventional-billionaire-is-revolutionizing-philanthropy-by-closing-his-8-billion-found.

It is then a further step to link this to open access credit, but the above already describes its essential feature, namely the auto-allocation of excess capital by its users according to the economics of whether they use it to *develop* capacities (through the financing of education) or to *apply* capacities (by financing entrepreneurship).

4.9. From implicit to explicit (Divining theory in the practice – a question of methodology)

Our next task is to convert these thoughts into concrete instances of open access credit, leading eventually to the distillation, out of practice, of financial literacy seminars (the task of WP10: Dissemination). This, as we have indicated earlier, is essentially a matter of giving theoretical expression to generic observations about the logic and structure of accounting.

To move in this direction we first need to review our methodology. In rethinking the theoretical foundations of social innovation in finance and our social innovation of open access credit in particular, we began by looking at the practice of bookkeeping, gleaning from that, not a theory in the first instance so much as a description of accounting. From this we derived a number of precepts central to finance and modern economic life, but with the particular feature that they transcend the Left / Right, not-for-profit / for-profit divide.

From this point of view, it seems self-evident, as the individual case study on *Entrepreneur Capital* details, that the accounts and related structure of myriad youth projects and social enterprises can be reinterpreted, such that they can all be seen, in principle at least, as examples of how access to credit is not (yet) open, but could easily become so. For this, however, we need to rethink the current division of economic life into two camps – for-profit and not-for-profit, first and third sector, commercial and charitable undertakings – a division not supported by the logic and structure of accounting. On the contrary, accounting provides the very ground on which such dichotomous thinking and behaviour can be overcome.

Taxation

This, in the macro context, is directly linked to prevailing tax regimes which for the most part institutionalise the Left / Right divide, in that the basic idea is that we make money in one part of the economy, the private, for-profit sector, and then give some of it away in the not-for-profit sector (via the government using civil society or the third sector as its agency). For many reasons, ranging from the abuse of charities by money launderers to the emergence of computerised accounting, this 'structural' arrangement is becoming anachronistic and is being replaced by a simple forensic analysis of accounts that merely follows the money. Regardless of the juridical structure of an entity, whether 'private' or 'public', one looks to see how the benefit that arose within it was distributed. At its simplest, if the benefit is given to private people, then income tax is levied to ensure funding for the 'public' economy, that is to say, in order to finance things we have or use in common such as hospitals or the road system. But even here serious 'abuse' can occur, as when a corporation offshores itself or pays its employees in part with wages, and in part by encouraging them to cover any shortfall via tax credits – thereby externalising to the public balance sheet what should really be charged to shareholders.

Behind today's taxation regimes is a wide range of wealth equalising, Robin Hood thinking – all of it perfectly understandable given our history to date – a history characterised by capital having been typically the province and privilege of certain groups, not of human beings generally. But in our time, in the form of young people and social entrepreneurs especially, people generally now need access to credit. It is not so much jobs that people need, as capital with which to fund either their education or their enterprises. This means, however, that we need to rethink our understanding of capital by fliping our approach to history, by looking instead to a future in which individuals are allocated capital, not because of their status, etc., but because their use of it, warrants it, and because they can demonstrate this through their financial planning (see *Appendix: Concerning financial literacy*), the key in turn to subsequent successful conduct of their affairs.

Computer technology

In today's world, with computers and simple accounting software available to all, one only needs to add financial literacy to the mix, ensuring that we all know how to do accounts and manage our own cashflow, and one can see how, in principle, we are already close to inhabiting a world that is flat and meritocratic as regards the allocation of capital.

This is not a new development. Computers and software accounting have been around for a long time, making it possible in Britain, for example, as long ago as 1988 to give school governors and teachers 'agency' and autonomy as regards the financing of their schools. When looked at in principle and when divorced from Margaret Thatcher's use of it to marginalise left-leaning councils, 'local management of schools' (LMS)[66] made the governors of primary schools, for example, the 'live' end of the educational financial system. Provided they acted in financially literate and disciplined ways, meaning ways that would survive an external audit, they could draw down their capitation rather than have it dictated to them. In other words, the technology and the governance necessary to a financially literate population has long been to hand. Unfortunately, in Britain's case, this was lost to sight because of the challenge it presented to governors, who were used to governance by 'the good and the great' and were not really expecting to be responsible for the balance sheets of their schools, and because of its reversal by subsequent political developments, although not completely so.

We mention this for two reasons. First, in LMS one had the technique required for the kind of generalised financial literacy that in turn is necessary if capital is to be freed for the future. Second, because such a technique gives practical ground to the conclusion of our comprehensive case study concerning 'curriculum neutral capitation', whereby those responsible for a school, assuming they are financially literate, ought to be entitled to draw down to the school the money needed to run it.[67]

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[66] Introduced in the Education Reform Act 1988 (widely regarded as the most important single piece of education legislation in England, Wales and Northern Ireland since the Education Act 1944), the LMS part of the Act allowed all schools to be taken out of the direct financial control of local authorities and handed to the head teacher and governors of a school.
[67] 'Curriculum neutral' because, as argued in the case study, it is a concomitant of open access credit that he who pays the piper no longer calls the tune.

Taken together, the kind of financial literacy that enables one, subject to professional and conventional auditing, to draw down the money needed to run a school is an example of open access credit. That is to say, both as an idea and in concrete instances, open access credit is already impliedly present. Indeed, a first step to recognising open access credit is to imagine its implicit existence. As with LMS, this can be an existing arrangement or practice that is simply not (yet) described in such terms.[68]

That this is so, we instance in our case study on *Entrepreneur Capital* where open access credit is also there for the seeing, provided the user of capital is free of the 'asset locks' and other constraints whereby, in effect, the providers of capital seek to micro-manage its use. In other words, the most effective way of perceiving open access credit is to take the accounts of a typical social enterprise and recast them without the grantor's micro-management. Of these there would be myriad examples.

4.10. Policy considerations

By that path one also arrives at a list of changes in practice and therefore policy that would be needed to switch open access credit from something implicit to something explicit, from a way of looking at and even recasting existing arrangements to grant-funding going forwards. Below is a resumé of such changes as formulated in the two case studies cited above.[69]

The comprehensive case study, *The financing of generalised education*, argued that

> "If 'creating economic space for social innovation' is about anything, it is about rethinking our understanding of capital, no longer only in terms of financing the means of production for the material (goods) economy, oft-times also in ways that enslave humanity, but also as the counterpart to the unfolding of capacities, and so as the potential enabler of people everywhere. This is especially the case in regard to financing the education of human beings…
>
> This depends however on the way generalised education is financed… whether its funding is a societal affair (an enlightened form of taxation or collective economic action) or an individualised affair [and on what] role gift-funded education (education funded by writing off excess capital) can play in creating economic space for social innovation."

We continued by saying that,

> "if the convention is maintained that he who pays the piper calls the tune, then the providers of capital dictate its use; but if this assumption is relaxed or, rather, replaced by the assumption that the use of capital is decided by its user, then there is no reason for the state, or any other provider of funds (neither corporations, markets nor parents) to also dictate the nature, content and organisational modality of education. These things then become the prerogative of educators (affirmed by those wishing to be educated)…

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[68] A similar story (discussed below in *11: Instances of open access credit*) could be told as regards the autonomous economics of local exchange trading systems (LETS), where accounting, often software based, is key.
[69] Although the citations may strike the reader as lengthy, they represent the essential argument of two very concentrated case studies and can hardly be distilled further, but thereby obviating the need for busy readers to study those case studies in detail.

> [As averred by] Derek Gillard (2011), when citing Jones (2003:95) … despite everything, the ideal … is 'the spontaneous and deep-seated tendencies of the school system, towards localised, piecemeal, unsupervised, *professionally led* [italics added] and progressive-influenced reform.' This, rather than the involvement of the state in the field of education, not only its content and 'quality', but even its micro-management to political ends...
>
> From a purely financing point of view, this would be a *sine qua non* of any form of funding that sought *not* to control the thing being financed… In particular, the proposition of curriculum-neutral capitation[70] allows for a rethinking of tax-funded education in a way that preserves the pre-financed and grant-funded feature of 'conventional' state funding yet frees education to be led by those whose profession it is."

Finally, the study gave thought to

> "the nature and development of higher education and in particular its method of funding and, the theoretical corollary, the idea of students being able to choose and in that sense drive their own education [which] comes down to their seeking out and affirming the education offered. The idea of marketised student loan funding is that students then exercise their freedom of choice, but this does not necessarily ensure the quality of what is 'on offer'. Among the many questions one can ask of student-loan funding, therefore, are these two:
>
> (1) Is this method – the banking concept of creating funds – more appropriate than (or as appropriate as) the ousted modality of essentially cash-to-cash financing?
>
> (2) Is it a form of capitalising capacities in ways that match Sen's 'capabilities' expectations?"

In short, the study argued that the 'logic' of the history of financing generalised education does not lead to preserving capital in financial markets by creating funds that then lend it on to students. The better, even proper, way to finance education is to circulate excess capital by, in this case, giving it away. In practice, that amounts to cash-to-cash finance, transferring excess capital from the part of the economy where it arises to another part, young people in particular, where it gets used up. In a picture, for every spring there needs to be a sink, for every sink a spring.

> "…the financing of … tertiary education in particular, needs a different type of capital – one where the benefits it gives rise to accrue to society, not to the provider of capital. This capital needs to be given, not lent. Its cover is not found in the realm of goods, but in the capacities it allows to come to expression and in the exercise of the capabilities this facilitates. An uneducated or ill-educated person is a net beneficiary of society; an educated person is a net benefactor.
>
> This type of capital 'behaves' differently. Notwithstanding today's inequitable wealth distribution, in principle and over time, as living standards increase and people develop aspirations beyond meeting the needs of material existence, capital can take on this second role... As its purpose evolves, so do the conditions on which capital is made available. In particular, as capital takes on the role of enabling the unfolding of capacities through education, access to it needs to become 'open', that is based on the users' possibilities and intentions, rather than those of the providers."

[70] See earlier footnote.

The study ended with the following comment, directly linked to this paper's discussion of shares in perpetuity. A major source of capital transfer would be effected if, for example,

> "a portion of the gains to Microsoft or Apple or Sony, etc., not accruing to their shareholders, but being 'siphoned off' into funding education… As things stand, this surplus is simply put back into the financial markets and causes yet more excess capital, itself a main cause of continuing [today's] technological expansion and technological unemployment."

In the individual case study ICS: *Entrepreneur Capital*, Section 2.7.2 on 'Measuring social impact via accounting' stated that

> "…the two chief metrics are profit and entrepreneur capital. Understood as the difference between income and expenditure, and assuming the prices received (income) and the prices paid (expenditure) conform to ethical and environmental concerns, profit can be regarded as a measure of the social *and* financial validity of an enterprise.
>
> As already noted, since in accounting terms the profit is transferred to the own capital account on the balance sheet, there can be no question of debating who owns it. The question is to what use is it put? In this study the distinction is made between allowing all profit to accrue entirely and in perpetuity to shareholders and allocating some of that profit to the entrepreneur in order to create his or her own economic space in which to innovate and take initiatives. In this sense, the amount and use made of entrepreneur capital can be seen as a metric for the efficacy of the (social) entrepreneur.
>
> In the same vein, all other accounting categories – stock levels, speed of turnover, liquidity ratios, etc. – are [also] metrics on some facet of an enterprise. And not [only] of the enterprise unto itself, but in relation to its environment, both social (e.g. customers and suppliers) and physical (e.g. use of finite resources).
>
> By this token, the social innovation of entrepreneur capital can be expressed in terms of the accounts of those who benefit from entrepreneur capital in lieu of grant funding. To give a crude example, the time taken to apply for grants can be tracked then multiplied by a remuneration factor to establish how much of the grant has already been spent applying for it. This can be compared to the immediacy of being able to access entrepreneur capital when an opportunity or an initiative arises.
>
> More complex, but also measurable, is the saving to a building company, for example, if a young person joins it ready trained up … an important fact needs noting, namely, the costs of the training appear in the accounts of [the training programme], but the benefits arise in the building company [as also] on the balance sheet of the young people now able to earn a living rather than languish on benefits, which in themselves [seen from a societal point of view] are expenses without gain.
>
> [To this one can add,] the (measurable) number of young people who are able to migrate from benefit-funded existence to (self-)employment [as well as] subtler impacts and improvements in terms of self-confidence, social recognition, financial independence, having one's own 'space', and so on.
>
> Lastly, one can look at the immediate benefits in terms of a locality and its citizens, but also the more distant ones of better and more effective use of national resources, streamlined financing, and the depoliticising of economic regeneration (bearing in mind that entrepreneur capital in effect 'hybridises' capitalism and socialism)."

Much is discussed today in terms of the social impact of finance, often assumed to be negative when merely 'financial' and positive when 'social'. Obviously, much then depends on how one defines and therefore measures such things. The argument of this paper is that

accounting itself can serve as a measurer of social impact, leading to identifiable changes needed in concept, policy and practice. Distilled from the above-quoted passages, here is our list (the numbering links to the *Appendix*):

1. Rethink our understanding of profit as a social metric rather than a quantity of money one can pocket

2. Revise our understanding of capital by linking excess amounts to capacities rather than physical means of production

3. Transfer allocation decisions to users rather than providers of capital

4. Return to cash-to-cash rather than funded financing of education (and other social provision)

5. Avoid lending against collateral

6. All of the above, along with practical training in bookkeeping and accounting, embedded in the teaching of financial literacy, to young people especially.

In Beckert's terms, many of these things come under the headings of both cognitive frames and institutions because there is little point, or even possibility, of their arising conceptually unless they are born of, or directly given effect in, practical life.

4.11. Instances of open access credit

Wide-ranging and far-reaching though the components of our list are, even 'politically impossible', they are nonetheless conceivable. Why we cannot do what we can conceive is a topic too large for this paper, which is already extensive. We may, therefore, have to content ourselves with capitalising capacities and open access credit as something more implied than operational in today's world; more a challenge to cognitive frames than a description of new ways of doing. Except that, if economics is wrought thought, then to think is half way to having done something.

At the level of thinking, therefore, as conceptual deeds if nothing else, capitalising capacities and open access credit clearly have significant consequences and, indeed, advantages, both for those whose capacities are capitalised and for society in general, insofar as we are all affected by the uncertainty consequent on allowing too much capital to flow into financial markets.

To use Sen's terminology, *internally*, at the micro level, capitalising capacities by way of open access to credit puts air beneath the wings of young people and social entrepreneurs alike. Not only does their recognition act as a spur to responsible initiative taking, but the ability to manage their borrowing from within, rather than at the behest of lenders, can make or break their success. *Externally*, in macro terms, one gives capital and credit a new foundation. Instead of material production being trumped by financialism, thus placing the

real economy in constant jeopardy from the financial economy (to wit, the earlier cited *City 1, Industry 0*), preserved capital is allowed to circulate, such that excess capital is not 'stocked' in financial markets but used up in the creation of new values.

Where, then, are the instances of open access credit? These can be of two kinds – implicit and explicit. As noted above, by implicit we mean an existing arrangement, practice or institution that may technically be an example of open access credit but not conceived or named as such.

We have already mentioned local management of schools (LMS) in England, while our individual case study, *Entrepreneur Capital*, details one of what could be many such cases, of social enterprises were their terms of funding not only to follow the grantees' initiatives – since these, not the grant-making are the drivers of change – but also leave them free as to how they use the funds. After all, to do so would simply mean trusting that the same social conscience, proximity to the problem, tenacity of purpose, and preference of social rather than personal gain that animate their request for funding (as also presumably the motives of the funders) would also underwrite their use of it.

Complementary currencies

Another important example would be complementary currencies (explored in CrESSI terms by Martijn van der Linden in his contribution to WP7[71]), and in particular local exchange trading systems (LETS). The money in such systems is very precisely a means of exchange between its members and is not issued by a bank of any kind, whether social, commercial or central. The money is in fact an accounting system that tracks the exchanges between members and records their values as determined by those members. It is therefore entirely born of and managed by the members. Not only that, but the terms of using it – especially when used for more than a month and so in effect changing from delayed payment to borrowing – are also determined by its users independently of any other group or external authority. This autonomy of term-setting is a feature of open access credit.[72]

More generally, one can look at the motivation, with varying degrees of awareness, of the growing number of 'ethical' investors. Although in principle they are still for the most part looking to preserve rather than circulate capital – that is, they seek a return and eventual repayment – from a strictly maximised shareholder value perspective they contradict everything Milton Friedman claims as socially valid, replacing it with an ethics of 'commitment', accepting a 'green dividend' in lieu of cash in the case of organic farming, for example.

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[71] Entitled *Empirical research on complementary currencies systems in the Netherlands*, this study was distilled from the more comprehensive concept of open access credit through the more general idea of 'innovative financial arrangements', to the specific case of complementary currencies.

[72] On a technical point, although LETS accounts often show the reflecting balances of members when they trade (the vendors' going up and the buyers' going down), these are in fact single entries in their cash books. The true record would go via the capital account, that is, via the balance sheet. It is also the case that any sale is financed by the vendor, with the sale becoming instantaneously an account payable. If the buyer pays cash then the loan is repaid directly after the transaction has occurred. If paid at the end of the month the vendor clearly has a loan out to the buyer, for it is the money that is expected at the end of the month not the returned good, still less a returned service!

In other words, wherever the prerogative of the lender to set terms is relaxed in favour of the borrower, open access credit can be said to be operative. One may be tempted to describe implicit examples as fictional, but that is mainly only so at the level of nomenclature. In many cases of 'social' finance it would be but a small step to derogate the determination of terms formally to the borrower. Indeed, although often per *force majeure*, much debt restructuring and debt forgiveness is predicated on the fact that the conditions envisaged when a loan was made no longer obtains and one has to rebase the financing on current conditions. Even a 'market correction' can be seen in these terms, which may be why Warren Buffet, the US investor, famously does not sell shares in a down-turning investment. Values can go up and down; manipulation and fraud to one side, the reality is far more that lenders chase rather than determine conjunctures.

Shares not loans

A final, increasingly prevalent, form of open access credit is when 'social' financiers shift from making loans to buying shares, the counterpart of social entrepreneurs using share vehicles. For then the money is 'in' the enterprise, at the disposition of the entrepreneur not the investor. Except, and here we glimpse a huge untapped dynamic, that shareholders, unlike lenders, can retrieve their money via the secondary market, leaving the enterprise whose shares they trade unaffected. The capital only comes 'out' at liquidation of the enterprise.
In other words, the modality of open access credit is more prevalent than one might think. For instances to be explicit, they would need to be expressly structured such that the capital provided was available to its users on terms they decided.

Although in Switzerland and so outside the European Union, L'Aubier s.a.[73], a company in Neuchatel, is structured such that its majority shareholder is a simple association, whose aim and effect is to vest the terms of use of capital in those who run the business, provided in doing so they follow criteria of sustainability, fair pricing, fair remuneration, minimal environmental harm, and so on. Its own shareholding is financed by a 10% premium levied on the minority shares. That is to say, those who invest in L'Aubier (currently 1,500 plus people, of whom 857 are shareholders[74]) knowingly repudiate maximising shareholder value thinking and forgo any rights associated with it, and do so to such an extent that they enact *and finance* their own 'disadvantage'.

Again, many companies could be restructured along the lines of such a business model. It is not the case that the mores associated with it cannot, let alone do not, exist; it is more true to say that the standard constructs used today do not speak to, educate us about, or allow us to give such values expression.
But that is 'now'. Tomorrow there may be much more financing of this deliberate kind – for what else is the ultimate trend of much of today's 'social' finance? In terms of open access credit, its main hindrance is the background idea that even 'social' finance is predicated on the preservation of capital, with entrepreneurs dancing attendance on financiers (however

[73] See www.aubier.ch.
[74] 1,572 made up as follows: 714 shareholders who subscribed for 4.5 million in voting shares worth CHF 1,000.- each; 143 shareholders totalling CHF 1 million, in non-voting shares worth CHF 5,000.- each; 185 direct loans totalling CHF 3.7 million at an average interest rate of 1.0%; and 530 bondholders subscribed bonds derived from five tranches valued at CHF 10,000.- each over a period of 5 years and totalling CHF 13.0 million. (Source: http://www.aubier.ch/en/partners.php)

well-intended) rather than financiers recognising that the mere ownership or provision of capital does not maintain, let alone increase its value. That is achieved by the use made of it by entrepreneurs, depending in turn on their skills, 'nous', capacities.[75] This is why in *Entrepreneur Capital* we argued for a new class of share whereby a significant portion of internally generated capital (profit) would accrue to the entrepreneur rather than the shareholder.

Sharing economics

Another example, albeit again perhaps a pioneer rather than the norm[76], is the shared gifting programme among Waldorf schools in the Mid-states of the USA[77]. Here, in essence, the income from a fund is made available to a group of schools, whose bursars meet and share their budgets, in order to allocate the money between them according to their combined overall perception of their various needs. This allocation then governs the transfer of funds to each school. The availability of the funds in the first place is thanks to the original donor of the capital and dependent on its yearly performance, etc., but the use is determined by the exigencies of the schools that then receive its allocations.
Other papers in this Work Package will describe other forms of non-MSV financing. In their various ways, they belong to the growing movement of peer-to-per finance – both loans and gifts. Crowd funding is another obvious example, where the person needing the money states his or her needs and terms and then waits to see how other people, often unknown to him or her, respond. To link this to EU policy considerations, one need but visit the website of the European Sharing Economy Coalition[78] to see how broad and comprehensive this new development is, both in concept and in practice.

Its website states that: "The Sharing Economy (otherwise known as collaborative economy or collaborative consumption) refers to economic and social systems that enable shared access to goods, services, data and talent as opposed to ownership. These systems take a variety of forms but all leverage information technology and peer-to-peer communities to empower individuals with the distribution, sharing and reuse of excess capacity and underutilised assets (i.e. low frequency of use) in goods and services."

Admittedly, its reference to finance is understated, but that reflects one of our main arguments – the huge range of social change that people are engaged in or wanting to have happen today is hampered by the lack of the one thing on which such change in the end relies – open access to credit within a paradigm that matches and indeed enables the autonomy, agency and self-empowerment that those promoting such change champion (to wit, the capabilities approach of the CrESSI project).

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[75] More so than market conditions, circumstances and conjunctures. Interestingly, in Islamic finance, where interest charging is eschewed in favour of profit-sharing, the entrepreneur is understood to be an agent of society. If events go against hi or her, the investors, not the entrepreneur take the 'hit'.
[76] But to the tune of USD 5M so far.
[77] See http://rsfsocialfinance.org/shared-gifting/
[78] See www.euro-freelancers.eu.

4.12. Advantages of open access credit and circulating capital

We conclude this paper with a discussion, albeit cursory, of the advantages of open access credit and circulating capital, especially in regard to marginalisation, which we argue is primarily and technically a problem of capitalisation, not income, and therefore a problem of credit-marginalisation.

We begin with a list of the monetary and creditary advantages enumerated by Martijn van der Linden for the WP7 questionnaires[79], followed by a review of the considerations made in WP6: *Public Policy, Social Innovation and Marginalisation* in regard to social impact bonds. (Related papers in this project, including those in this deliverable, cover other dimensions of this field.)

WP7: Integrated Case Studies (Quantitative)

Of the advantages identified by Van der Linden, we focus on those of a financial kind[80] and in particular those linked to financial literacy (the numbering links to the *Appendix*):

7. Improved understanding of the theory and practice of bookkeeping and accounting;

8. Informational and operational benefits that flow from (1);

9. Better understanding of monetary and macro-economic issues (*inter alia*, inflation, monetary policy and credit creation);

10. Better comprehension of precepts, policies and instruments of finance;

11. Consequently, a better match of types and amounts of funding;

12. Leading to enhanced liquidity and cashflow.

It is worth noting the cascading sequence of the above points, leading from ‘cognitive framework’ considerations into policy and practice. In other words, unlike much of today’s socio-economic landscape, they entail no disconnect between theory and practice, concept and behaviour, macro and micro.

Social impact bonds
To précis the report[81] from CrESSI partners researching social impact bonds, their focus is on the third sector or civil society and how private capital can displace governmental (i.e. tax-funded) provision of finance, thereby easing pressure on the public purse at the same time as transferring risk (of loss of capital) away from governments. To quote from the CrESSI paper: ‘Social impact bonds are essentially payment-by-results contracts that leverage private

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[79] *Empirical research on complementary currencies systems in the Netherlands*, op.cit.
[80] One could, of course, also list a wide range of social, cultural and other non-economic benefits, but that is beyond this paper’s remit and focus.
[81] Social Impact Bonds: Opportunities and Challenges for Social Innovation, Daniel Edmiston, CRESSI Deliverable 6.4.

social investment to cover the up-front expenditure associated with costly social and welfare services. [They] tend to be preventative in nature and focus on achieving one or more specified social outcomes … intended to focus on tackling the causes of social exclusion and thereby reducing long-term public expenditure in key policy domains.'

Quite where this risk ends up is hard to say. Notionally, with the private investors, but at what rates of return and to what benefit or detriment of civil society is not readily identifiable. For example, the above-quoted passage goes on to say, 'the theoretical cost-savings accrued by the public sector are used to fund the service and cover the dividends paid to private social investors.' What is this other than shorthand for corporatising a previously tax-funded third sector? To put the point more pithily, what do social impact bonds do other than deliver civil society into the hands of financial markets or at least the precepts that animate such markets?

For what does 'value for money' mean? Or 'investment ready'? Or the 'entrepreneurial approach', given that most people assume that social entrepreneurs abide by a different code of conduct than 'normal' entrepreneurs. The report cites 5 benefits:

i) 'The length and regularity of interaction between practitioners and service users.'

ii) 'Increased responsivenesss of their service.' But in terms of which cognitive framework?

iii) A way 'to demonstrate the value of their operation through evidenced effects and enhanced social metrics.'

iv) 'An effective system of coordination between a range of cross-sectoral stakeholders.'

v) Claims of 'a greater degree of freedom, flexibility and autonomy for civil society organisations to deliver innovative welfare services.'

Offsetting these gains, the report goes on to cite 6 main challenges:

i) Increased micro management and intrusion.

ii) 'Excessive' reporting to investors.

iii) Disproportionate administration.
iv) The need to be 'investment ready'.

v) Presupposition of higher levels of financial literacy.

vi) Uncertain longevity of the scheme.

The concluding part of the report also mentions the consequences in terms of income streams, but again it pays no attention to what is arguably the real problem, namely, the type and terms

of capitalisation, including maximising but retaining internally generated capital (profit). In terms of the often short-termist investment horizons of today's private sector, the economics of marginalisation means a long lead-in before profit can be expected, let alone distributed, and, indeed, the need for capital write-downs and even outright donations in the first place (as discussed elsewhere in this paper).

Since such strategies can be achieved by outright giving, conventional 'patient' investment, or modern philanthropy, it is difficult not to see social impact bonds as little more than a technique for displacing or crowding out the state, as is the averred philosophy and indeed aim of today's prevailing neo-liberal paradigm.[82] In such regards, circulating capital and open access credit have quite distinct advantages. Principally,

13. They entail all terms and types of capitalisation deriving from the use made of capital, not the lending of it.

14. The user has the autonomy of 'own capital', of which profit is a subset.

15. They are not politically conceived or managed constructs and so operate independently of the changing fortunes and fashions of political life.

16. Because undergirded by precise, meaningful (in terms of the use made of capital) and up-to-date accounting, the reporting requirement is little more than the standard 'Notes to the Accounts' with such additional

17. commentary as is already the norm when auditing companies, CICs and charities. Indeed, it would arguably be less, if, as posited here, their economics excluded externalities and the accounting was socially metric.

4.13. Conclusion

This, then, is our conclusion. Namely, that if the economic problems experienced by 'the marginalised' are to be effectively addressed in ways that 'crowd out' the neo-liberal paradigm, we need to reconceive capital on a twin value basis (not just a labour-based theory of value in its various guises) at the same time as we give up the preservation of capital in favour of circulating it. The financial medium that represents both these things is open access credit and the technique that will allow us to cross from this side of the river to the other without falling in, is financial literacy predicated on accounting when the latter us understood as a means for perceiving and so managing economic life for all our benefit, not merely as a tool of tax avoidance or profit-maximising.

[82] It puts one in mind of Britain's populist privatisations of state assets, effected by under-pricing the initial price and barring institutional acquisition on Day 1, so that on Day 2 people who had never owned shares and were often ideologically biased against them, found themselves tempted into quick gains and thereby terminally compromised as regards those ideologies.

Appendix: Concerning financial literacy

1. Rethink our understanding of profit as a social metric rather than a quantity of money one can pocket.

2. Revise our understanding of capital by linking excess amounts to capacities rather than physical means of production.

3. Transfer allocation decisions to users rather than providers of capital.

4. Return to cash-to-cash rather than funded financing of education (and other social provision).

5. Avoid lending against collateral.

6. Practical training in bookkeeping and accounting, for young people especially.

7. Improved understanding of the theory and practice of bookkeeping and accounting.

8. The informational and operational benefits that flow from (1).

9. Better understanding of monetary and macro-economic issues (*inter alia*, inflation, monetary policy and credit creation).

10. Better comprehension of precepts, policies and instruments of finance.

11. A better match of types and amounts of funding.

12. Enhanced liquidity and cashflow.

13. Terms and types of capitalisation deriving from the use made of capital, not the lending of it.

14. The user has the autonomy of 'own capital', of which profit is a subset.

15. Apolitically conceived and managed constructs that operate independently of the changing fortunes and fashions of political life.

16. Because undergirded by precise, meaningful (in terms of the use made of capital) and up-to-date accounting, the reporting requirement is little more than the standard 'Notes to the Accounts' with such additional commentary as is already the norm when auditing companies, CICs and charities. Indeed, it would arguably be less, if, as posited here, the economics excluded externalities and the accounting was socially metric.

Slightly amended, the above list of topics is lifted from Sections 10 and 12 of this paper and can in effect be seen as a blueprint for change. It is these changes we will have in mind when designing our proposed contribution to WP10. This will entail a financial literacy curriculum based on the evaluation of actual cases, thereby converting theoretical considerations (albeit grounded in anecdotal experience) into empirical data, even if, pejoratively seen, such methodology might amount to reversing theory out of practice.

In this appendix, we cast our eye forward to the kind of financial literacy that will be the focus of that contribution. This will not be the standard treatment[83] predicated on preserving capital and accepting today's financial system, based as it is on markets and banking, but will assume the circulation of capital by passing it from competent person to competent person – competent because they use it to achieve their goals.

The kind of financial literacy that circulating capital and open access credit presupposes has been outlined in our paper on accounting and social innovation for WP3: *Measurement Approaches to Capturing Social Innovation Impact*.[84] As with the core argument and methodology of this paper, its treatment stays close to the techniques of bookkeeping and the structure of accounting, facts of economic life that are both practical and ideologically neutral[85], and which we take as given.

Central to such financial literacy is not only a viable theoretical or conceptual understanding of bookkeeping and accounting, but the ability to apply this to one's own affairs. As well as the three main precepts of adequate profit, appropriate capitalisation and positive cash flow management[86], this entails the ability to devise and adhere to, or navigate by, a financial plan cast over the life of one's project or at least five years in the case of a business intended to be on-going.

In particular, it is the use of a financial plan that enables one to envisage, plot and then achieve the level and type of capital one needs, with the users of capital themselves identifying the type and amount of credit their projects warrant. It is this that enables access to credit to be or become open – because the borrower develops the kind of awareness traditionally expected only of lenders or lending agencies.

Although aphoristic, the following sketch depicts the kind of financial plan we have in mind. It comprises the key aspects of a practical nature, derived from research conducted over many years (and still on-going)[87] and in many contexts, using the medium of workshops that are (i)

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[83] *Child Youth International* in Amsterdam, for example, has extensive worldwide programmes designed to make people from very young ages 'bankable'. Their research make no mention of bookkeeping or accounting.
[84] *Accounting, Social Innovation and Finance – teaching financial literacy using double entry bookkeeping*. C. Houghton Budd, April 2015.
[85] Think tanks of all ideological and political persuasions have to do their accounts in the same way. What they use their funds for may differ, as also their view of life, but for the structure of accounts that is a matter of indifference.
[86] For an initial outlining of this work, see *In the Shoes of Luca Pacioli*, in *International Handbook of Financial Literacy*, Springer, Berlin 2016.
[87] For many years, under the two rubrics of 'Colours of Money' and 'Air beneath Your Wings', the writer as given workshops in both educational and consultative styles, to both lay and professional groups, in many countries and cultures in both 'first' and 'third' worlds, in contexts ranging from Brazilian favelas and US ghettoes to major bank executives, and in the presence of or in collaboration with finance and accounting

open to people from all walks of life, both lay and professional, and of all ages above 15 (and occasionally younger), (ii) held in many different countries and cultures, and (iii) attended by accountants and auditors. Often linked to participants' actual experience in running businesses and organisations of various kinds and scale – from local organic farms to major corporations, and from parish councils to central banks – such 'action research' has been subject to verification by a combination of a to-and-fro process between researcher and researchees, and by 'triangulation' of data from a wide number of cases – Yin's (2013) multiple case study methodology.

	PM				PQ				PA			
	B	A	D	Comment	B	A	D	Comment	B	A	D	Comment
Income												
-	-	-	-		-	-	-		-	-	-	
-	-	-	-		-	-	-		-	-	-	
-	-	-	-		-	-	-		-	-	-	
Expense												
-	-	-	-		-	-	-		-	-	-	
-	-	-	-		-	-	-		-	-	-	
-	-	-	-		-	-	-		-	-	-	
Profit	**-**	**-**	**-**		**-**	**-**	**-**		**-**	**-**	**-**	
Assets												
-	-	-	-		-	-	-		-	-	-	
-	-	-	-		-	-	-		-	-	-	
-	-	-	-		-	-	-		-	-	-	
Liabilities												
-	-	-	-		-	-	-		-	-	-	
-	-	-	-		-	-	-		-	-	-	
-	-	-	-		-	-	-		-	-	-	

Sketch of a financial plan

The financial plan is shown divided into PM (per month), PQ (per quarter) and PA (per annum) periods, corresponding to typical reporting requirements for management, investors and tax authorities respectively. Cast across a relevant timeframe, it comprises 5 main elements:

1) The Income and Expense account (aiming for adequate profit)

2) The Balance Sheet (based on appropriate capitalisation)
3) A solid line representing the need for (a) monitoring and maintaining positive cashflow and (b) plotting the break-even moment

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professionals. These workshops are on-going in two particular cases: a youth bond project near Buenos Aires in Argentina and a town regeneration scheme in Folkestone, England.

4) An area within the curve below the grid representing the call on liquidity from outside the enterprise, i.e. from the rest of the economy.
5) Columns representing budgeting (B) based on the entrepreneurs' images or expectations of what they will achieve, the actual results (A) based on regularly and methodically maintained accounts, and the difference (D) between B and A, which shows the variations (both positive and negative), thereby providing the key navigational aid (*Comment*) to ensure that the enterprise reaches its stated 'destination'.

Such a financial plan not only presupposes that entrepreneurs can maintain their accounts, but also that their accounts are an accurate reflection of what is really happening to, in and around their enterprise, contrasted to what they imagine, hope or expect. It also, but very importantly, assumes the ability to conduct a self-audit. That is to say, to analyse forensically one's own performance from the points of view of investors, tax authorities and analysts – all of which is normally typically done by outside parties such as banks, auditors, and so on, but which a financially literate person would learn to self-apply.

In other words, the financial plan enables entrepreneurs not only to have a view *outwards* as to what they expect and intend to do, but also a view of their undertakings as seen *inwards*, from their social environs – from the point of view of those they affect in both real and financial terms. In effect, a self-generated, multi-stakeholder view.

Furthermore, if by fair pricing[88] every value recorded in the accounts is without externalities of any kind, such an audit also meets today's various 'people, planet and profit' criteria devised by different groups to ensure that a financial profit is also a social profit. The financial plan and self-audit outlined here enables an enterprise to use its accounts to do just that, to show that it is at once ethically, environmentally and financially *performant*.

Finally, financial literacy of this kind and calibre is designed and intended to demonstrate to borrower and lender alike, that the user of capital has (or can develop) the kind of awareness usually reserved for 'experts' and so is able to determine how much credit a projects *warrants* and on what basis. Whether one uses terms like 'citizenised central banking' or 'democratised finance', the point is that, in principle, such financial literacy gives financial and economic agency to everyone, not just some. Capital thereby becomes classless, an instrument openly available to all, in return, as it were, for their educated, conscious and responsible – *per* Keynes writing in the *Tract of Monetary Reform* (1923), 'deliberate and scientific' – use of it.

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[88] See Ch. 10 'Full and true accounting' in *The Right On Corporation*, op. cit.

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5. The Problem of Social Collateral in Micro-lending

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5.1. Introduction

Since 1976, when Muhammad Yunus launched his experiments (Yunus, 1999), microcredit or, more generally, microfinance[89], has proved to be the most important innovation in providing financial services to the poor. Microcredit has become a huge and quickly developing industry: according to the latest figures of the Microcredit Summit Campaign, the total number of clients with a current loan increased from 13 million to 211 million between 1997 and 2013. Of the clients at the end of 2013, 114 million were reported among the poorest.[90]

Within microcredit, group lending is by far the most celebrated innovation. It has shown how unconventional contracts can work in a field, which had been previously unattainable for the usual banking services. The essence of group lending is the substitution of the usual banking collateral with group liability that can be interpreted as a kind of *social collateral* (Karlan et al, 2009). Group lending is not an exclusive practice in microcredit, but there is a trade-off between the share of group lending within the portfolio of microcredit organizations[91] and the outreach of the poor (Cull et al., 2007).

Yunus' innovation, the practice of group lending, and the Grameen Bank built on this practice bears all the features of social innovation. It is clearly a new practice, based on a new idea "that intentionally seek[s] to change power relations and improve human capabilities, as well as the processes via which these solutions are carried out" (Nicholls and Ziegler, 2015:2). *The main question of this paper is whether microlending in general and especially the use of social collateral is really a suitable device to change power relations in favour of very poor marginalised people.*

The views on the actual poverty alleviating effect of microcredit are extremely divided in the literature. Advocates of microcredit see it as the starting point of a revolution in banking access. More enthusiastic supporters even consider it a source of major social transformation (see e.g. Marguerite Robinson's book, *The Microfinance Revolution*). This view is well expressed in the fact that in 2006 the Nobel Peace Prize was awarded jointly to Yunus and the Grameen Bank "for their efforts to create economic and social development from

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[89]Beyond microcredit, microfinance contains also microsaving, microinsurance, micro-franchising, and so on. The scope of this paper is limited to problems in the field of microcredit.
[90]Seehttps://stateofthecampaign.org/2015/12/15/2015-report-number-of-clients-reached/. The exact meaning of the term 'poorest' is not defined in the report.
[91]In the microfinance literature 'microfinance institution' (MFI) and not 'microfinance organisation' is the common term, but in the context of CRESSI (or more broadly, in institutional economics) this would be equivalent terminology.

below"[92]. By the 1990s, microfinance had become the most generously funded poverty reduction policy. "[M]icrofinance is the icon of millennial development, crystallizing a multitude of aspirations, agendas, interests, and desire" (Roy, 2010:188).

A huge amount of inspiring stories is presented in the microfinance literature and in other publications where poor people, typically women, were able to start a profitable business with the help of a micro loan and in this way were able to substantially improve the lives of their families. Many regard micro-lending as a unique device promoting women's empowerment (for a summary of this topic see Armendáriz and Morduch, 2010: Chapter 7).

Besides plenty of anecdotal evidence, relatively few methodologically rigorous impact evaluations have been carried out and those, which have, do not show robust statistical impacts on the lives of those involved. Duvendack et al. (2011) presented a comprehensive review and re-examination of the former investigations. The authors found no statistically convincing evidence "to either support or contradict the main claims of beneficence of microfinance" (p. 3.). Based on the impact analysis of the Indian SEWA Bank, Duvendack (2010) concludes in a more explicit way: "Finally, not only do these data and methods not provide support for the idea that microfinance is highly beneficial to the poor, *rather than perhaps benefitting a slightly better off group*, but it leaves open whether microfinance is of any real benefit at all, since much of the apparent difference between microfinance participants and controls is likely due to differences in their characteristics rather than the intervention per se" (p. 44, italics added).

This *mission drift* – serving relatively better-off customers, who have nevertheless no access to loans under traditional bank practices, rather than the poorest – is the direct consequence of the commercialization of microfinance. As Armendáriz and Morduch points it out, "this has been a tricky transition, given that donors and social investors often gave initial subsidies earmarked for institutions to serve the most disadvantaged" (2010: 239).

The January 2015 issue of the *American Economic Journal: Applied Economics* was devoted to the impact evaluation of microcredit presenting six randomised evaluations in six different countries (Banerjee et al.; Tarozzi, Desai, and Johnson; Attanasio et al.; Crépon et al.; Angelucci, Karlan, and Zinman; Augsburg et al.; all 2015) and one recapitulative paper (Banerjee, Karlan, and Zinman, 2015). In summary, the papers found a consistent pattern of modestly positive, but not transformative, effects. None of the six studies found robust evidence that the investigated programmes had increased the household income of the participants.

Even if we have modest positive results, it is highly debatable whether randomised impact evaluations are conclusive from a development policy point of view. Besides other problems, internal validity does not follow even from high external validity (Ravaillon, 2009). Deaton (2009) suggests turning from experimental project evaluation towards the evaluation of theoretical mechanisms.

Impact evaluations investigate actively operating programmes with performing clients, thus the consequences of the complete failures are out of scope. The first large microfinance

[92] https://www.nobelprize.org/nobel_prizes/peace/laureates/2006/

meltdown occurred in 1999, in Bolivia, but during the crisis, serious problems had accumulated, and a series of 'subprime-style' meltdowns occurred among others in India (Andra Pradesh), Morocco, Nicaragua and Pakistan (see Bateman and Chang, 2012; Ghosh, 2013).

Regarding the fact that microfinance activities have absorbed a significant proportion of development resources both in terms of finances and human capacities, it is a crucial question if these resources could have been utilised better. Based on this reasoning – and other arguments to which I will return later – Bateman and Chang conclude, "microfinance actually constitutes a powerful institutional and political barrier to sustainable economic and social development, and so also to poverty reduction" (2012:13).

In a former CrESSI paper, I argued that without significant capital injections underdeveloped areas and severely disadvantaged people cannot improve their situation (Molnár, 2015a). The dogma of financial self-sufficiency, moreover profitability, as a policy requirement placed upon microcredit activities is an obstacle to real social inclusion. This study aims at the closer investigation of the special problems of group liability and social collateral. In doing this I will refer to the experiences of *Kiútprogram* (*'Way out' programme*), a non-profit corporation providing microcredit and mentoring primarily to socially excluded Roma people in Hungary. (Details on the programme can be found in Molnár, 2015b and 2016.)

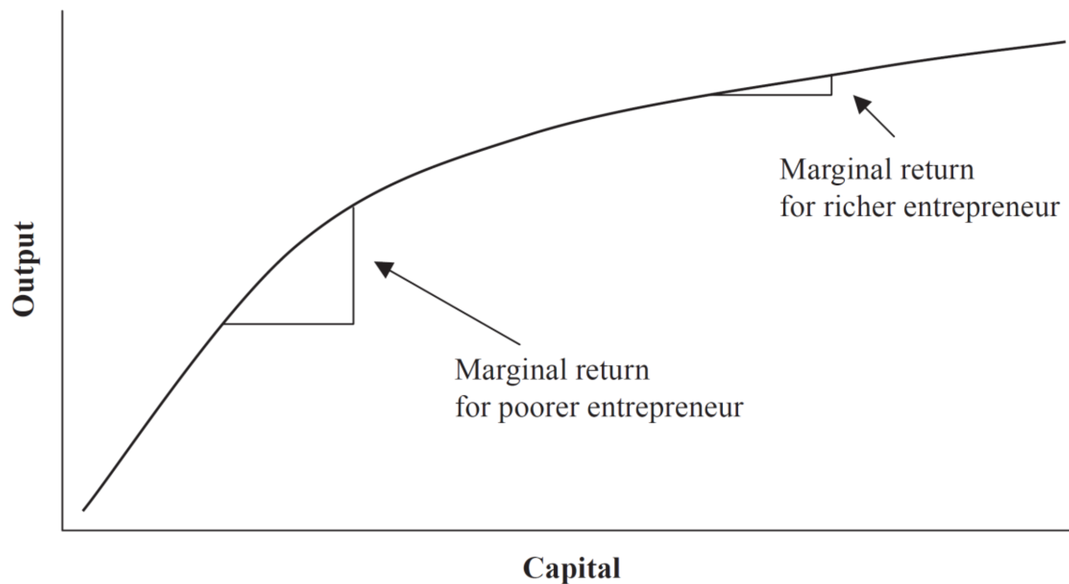
Of course, these experiences are very special. They are obtained from a relatively developed transition country and not from a poor developing one. Besides higher development, the existence of some kind of welfare state, the high tax rates in the formal economy (also at lower income levels), the extensive bureaucratic difficulties of starting a new business and the relatively low demand for unqualified work in the formal labour market are important differences. The central problem is not poverty alleviation in general, but the high level of marginalisation and social exclusion of certain social groups, especially those with low educational attainments. From a European perspective this approach is highly relevant. Nevertheless, the examination of the theoretical mechanisms could also be relevant in other contexts.

First, we review the banking problems, solutions to which can be expected from group liability; then we present the solutions offered. The next section outlines the problems of group lending, followed by the overview of some alternative solutions, including the solution applied by the Kiútprogram. The study is closed with a summary of its conclusions.

5.2. Why traditional banks do not finance the enterprises of the poor?

Describing the problem, we rely on the synthetic work of Armendáriz and Morduch (2010). In theory, if we assume a continuous, concave production function, the poorer entrepreneurs can reach higher marginal returns than the richer ones, and in this way, they are willing to pay relatively higher interest rates. The illustration presented in Figure 1 is typical of studies and presentations advocating micro-lending. (Later we return to the problems of this approach.)

Figure 1. Marginal returns to capital with a concave production function



Source: Armendáriz and Morduch (2010: 6)

However, poor borrowers cannot offer collateral as security to the banks and the banks have no information about them. The collection of adequate information would raise the transaction costs to an unacceptably high level. In this respect, the banks face three types of problems:

– adverse selection,
– ex-ante moral hazard, and
– ex-post moral hazard.

These problems are usually inextricably linked in the practice, but in theory, it is appropriate to discuss them separately.

Adverse selection

For the sake of simplicity, we distinguish between two types of borrowers: *safe* and *risky*. The difference stems from the riskiness of the chosen business. In the practice, of course, there exist plenty of different cases, but in this simple model, we assume that the revenue of the investment made by the safe borrowers is always a given quantity. It is an important assumption that the difference between the return of the investment and the loan (including the interest) is positive, moreover, that the difference is higher, too, than the borrower's opportunity cost. (The opportunity cost can be the reservation wage, or the amount of social support lost due to the new business activity).

Risky borrowers are either lucky or unlucky with a given probability. If they are lucky, they earn higher profits than safe borrowers do. If they are unsuccessful, they earn nothing and consequently cannot repay the loan. We suppose that the *expected* return of the risky borrowers is the same as the return of the safe ones. (If it were lower, the result would be

even sharper.) We also suppose that both the safe and the successful risky borrowers repay the loan (the other case is treated under moral hazard problems).

It can be shown that in the presence of risky borrowers the bank should raise the interest rates just to break even. However, the higher interest rate may drive out safe borrowers and only the risky ones remain, further increasing the bank's risk. The information asymmetry – the bank does not know who is safe and who is risky – would lead to an inefficient and inequitable solution. Inequitable in the sense that – if they are not completely pushed out of the market – the safe borrowers cross-finance the risky ones.

The so-called ex-ante moral hazard

Upon disbursing the loan, the bank has no information on the expectable efforts by the borrowers. We may suppose that if the borrower makes every effort, s/he makes a positive profit with certainty (subtracting again the opportunity costs of his or her efforts). In the other case s/he works only a little, or not at all (in this case, there are no opportunity costs), and earns a positive profit only with a low probability. Because of the risk, the bank would like to raise the interest rate, but it can be shown that above a given interest rate level (depending on the parameters) the borrower will no longer have an incentive to make efforts at all. Consequently, the bank would lend only if the borrower committed to work hard. However, the commitment would not be credible without collateral. This is clearly a trap for the poor.

I should note that, although widely used, the attributive *moral* is highly misleading in this context, and it can contribute to the stigmatisation of the poor. Based on the experiences with the Kiútprogram, I can say that the typical cause of the failure is not the lack of efforts, not laziness, but the lack of applicable knowledge, practice, and connections. The worse the initial endowment with different elements of social capital is, the higher the probability of failure.

Ex-post moral hazard

The term ex-post moral hazard refers to the case when the project is successful, but the borrower decides not to pay back the loan. Although it is partly an ex-ante phenomenon, I include here also the case when the borrower uses the loan for other purposes (for example repaying his or her outstanding debts to a threatening local loan shark), instead of starting a business. Without any collateral, the bank cannot enforce repayment.

For the sake of future reference in this case I present a simple formal calculation, following Armendáriz and Morduch (2010:50-51). Let us suppose that 1 unit of invested money yields revenue y with certainty. The value of collateral is w, the probability that the lender can seize the collateral is s, and the gross amount to be repaid (principal plus interest) is r. At rate r the lender breaks even.

In the case of repayment, the payoff of the borrower is $y-r$. In the other case, when she decides not to repay, her payoff is y if she can run away with the money and $y-w$ if not, the collateral is seized. That is her expected payoff is $(1 - s)y + s(y-w)$. *If we assume that there exist no inner motivations for repayment* (e.g. honesty), the borrower will repay only if her expected payoff is higher in this case, that is if

(1) $y\text{-}r \geq (1-s)y + s(y\text{-}w)$.[93]

Rearranging the equation, we get $r \leq sw$, that is, the borrower will repay if what she needs to repay is less than the loss of collateral weighted by the probability that the lender can seize the collateral. On the other hand, if $r > sw$ (and again assuming a dishonest borrower), then the borrower will not repay. In that case, the bank will not lend money if there is no collateral ($w = 0$).

Moneylenders versus banks

The question arises why these obstacles do not hinder the activity of local moneylenders. The main difference is that moneylenders are familiar with the potential borrowers, they know well their personal traits and family circumstances, so in their case information asymmetry is smaller between the lender and the borrower. (There are loan sharks who apply violence, or credible threats of violence against defaulting borrowers. This possibility is disregarded here, because local moneylending can work without it, too.) If the bank wanted to collect personal information on the potential borrowers its transaction costs would increase unacceptably.

5.3. The solution offered by group liability

Microfinance, especially group lending, is seen as a possibility in reducing transaction costs and overcoming information problems. In the case of Yunus' Grameen Bank model at the core of the lending activity, there is a voluntary, self-nominated group of five loan recipients, whereby the collateral is replaced by mutual moral commitment. (In the practice, there are cases also of mutual financial liability.) Loans are *sequential* in the sense that they are initially given to only two of the members. If the first two loan recipients make the payments on time, after 6 weeks loans will be granted to another two group members as well; then, after another 6 weeks, the group leader elected by the group members is granted a loan. If in the first 6 weeks a member fails to make a payment as agreed, he or she is excluded from the group and the others have to find someone else to replace this group member. Further loans are not granted until the excluded member is not replaced. In case of default by a group member – irrespective of the cause of the default – no member of this group ever receives a loan in the future. Chowdhury (2007) defines this feature as *contingent renewal*. Given that the loan periods are usually one year long and that the first loan is a rather small amount, without a next loan the stable continuation of the started business is at least uncertain.

This means that if a group member is not able to overcome his or her difficulties with starting the new business, refuses to make payments or uses the loan for purposes other than agreed, the remaining members have to face punitive measures. The moral pressure is often even harsher: at the joint meeting of the local groups they are held morally responsible (even reprehended) for not being able to persuade the non-compliant member to repay the loan.

In this way poor borrowers act as guarantors for each other, so the usual banking collateral is replaced by *social collateral*. "[N]etwork connections between individuals can be used as

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[93]It is only an aesthetic and not a mathematical issue, but in writings on the subject frequently $>$ and not $\geq$ is written in the corresponding equation. The implicit assumption behind the $>$ sign is that the poor choose the dishonest solution even if financially it would be all the same.

social collateral to secure informal borrowing […] The possibility of losing valuable friendships secures informal transactions in the same way that the possibility of losing physical collateral.” (Karlan et al., 2009: p. 1307-1308). The topic of the quoted paper is informal contract enforcement in social networks, but the notion of social collateral is applicable in group lending, too.

I briefly review now how group lending can remedy the problems of adverse selection and moral hazard. *The first crucial assumption of the related models is that the borrowers know each other’s type* (see e.g. Varian, 1990; Stiglitz, 1990). Under the conditions of group lending the “safe” or “good” borrowers have strong incentives to avoid the “risky” or “bad” ones, and in this way, homogenous groups will be formed. This will result in a segregated outcome, also referred to as “assortative matching”.

In the model of Varian (1990), this methodology is used to reduce the monitoring costs of the bank. Based on an interview with only one group member the bank can decide whether all of the group members are “safe” or “risky”. One solution is that after the interview the bank does not contract with the members of the “risky” or “bad” groups.

If we only face the adverse selection problem, even the interview is not required; the bank does not need the information on the type of the groups. With appropriate parameters (loosely speaking, not too high failure rate in the risky groups and not too high interest rate set by the bank), the successful group members may be interested in repaying for their defaulting peers in the risky groups. In the safe groups there is no similar problem, everybody repays only his or her own loan. This means that the risky borrowers pay (implicitly) higher gross interest than the safe ones, the inequitable cross-financing between the safe and the risky borrowers no longer exists. Another important effect is that the bank breaks even at a lower interest rate.

Turning to the issue of moral hazard, we make the second crucial assumption: group members can efficiently impose social or economic sanctions on each other in order to enforce intensive work and repayment. Anyone who deviates is punished with social sanctions. In the most moderate case, the social sanction is only the loss of valuable friendships, but it can take way more serious forms.

Based on formula (1) in the previous section I present now a very simple formal illustration of ex-post moral hazard in case of group lending. As previously, the revenue of 1 unit investment is y and the gross amount to be repaid is r. Now, s denotes the probability that in the case of strategic default (that is intentional non-repayment) the other group members can successfully enforce repayment. This action has a non-pecuniary cost for the defaulting borrower resulting from loss of reputation in his or her community. The value of this social punishment is denoted by w_2. If they are unable to enforce repayment then – according to the rules of contingent renewal – the members of the group are excluded from the possibility to receive a loan in the future. The present value of the future profit missed in this way is denoted by δw_1, where δ is the discount factor of the future event. (For the division of the punishment function into two parts in a much more complex model, see Besley and Coate, 1995). Now, analogously, the inequality (1) for group lending would be

$$y - r \geq (1 - s)(y - \delta w_1) + s(y - w_2). \qquad (2)$$

From this we get that a borrower will repay if the inequality $r \leq (1 - s)\delta w_1 + sw_2$ is fulfilled. If δw_1 and w_2 are large enough, the bank can reach a relatively high interest rate. If the discount factor, and consequently the first component on the right hand side of the inequality, is too small, the interest rate can be raised by increasing probability s. In practice, raising probability s means that the bank strives to increase the pressure on group members to apply social sanctions upon their non-achieving peers. This applies not only to ex-post moral hazard, but also to the problems of ex-ante moral hazard and adverse selection.

What are the main devices of this pressure? In addition to the already mentioned sequential lending and threatening to stop lending (contingent renewal), there exists a wide range of other psychologically based tools: frequent (usually weekly) repayment instalments, public repayments, village level group meetings, targeting women, and lifestyle rules indoctrination.

As Armendáriz and Morduch summarizes: "The essence of group lending is to transfer responsibilities from bank staff to borrowers." (ibid: p. 123)

5.4 Specific problems of group lending

I have presented four crucial assumptions of commercial microcredit, and the theory and practice of group lending:

1. The production function is concave in the capital; the marginal return to capital is relatively higher for the poorer than for the richer entrepreneurs.[94]

2. The main causes of the entrepreneurial failures of the poor are the following: riskiness of the selected enterprise, lack of sufficient effort and strategic default.

3. Potential clients exactly know each other's type, or they can get to know it at relatively small costs.

4. Group members can efficiently impose social or economic sanctions upon each other in order to enforce intensive work and repayment.

Now, I reconsider these assumptions.

The production function

The first one is true only if the other factors of the production function are identical for poorer and richer entrepreneurs alike: education level, entrepreneurial, financial and professional skills, business connections and so on. If the endowment of the poor with these elements of social capital is worse than the endowment of the rich, and in fact, this is the case, the production function for the poor slopes upward much slower than for the rich (Figure 2).

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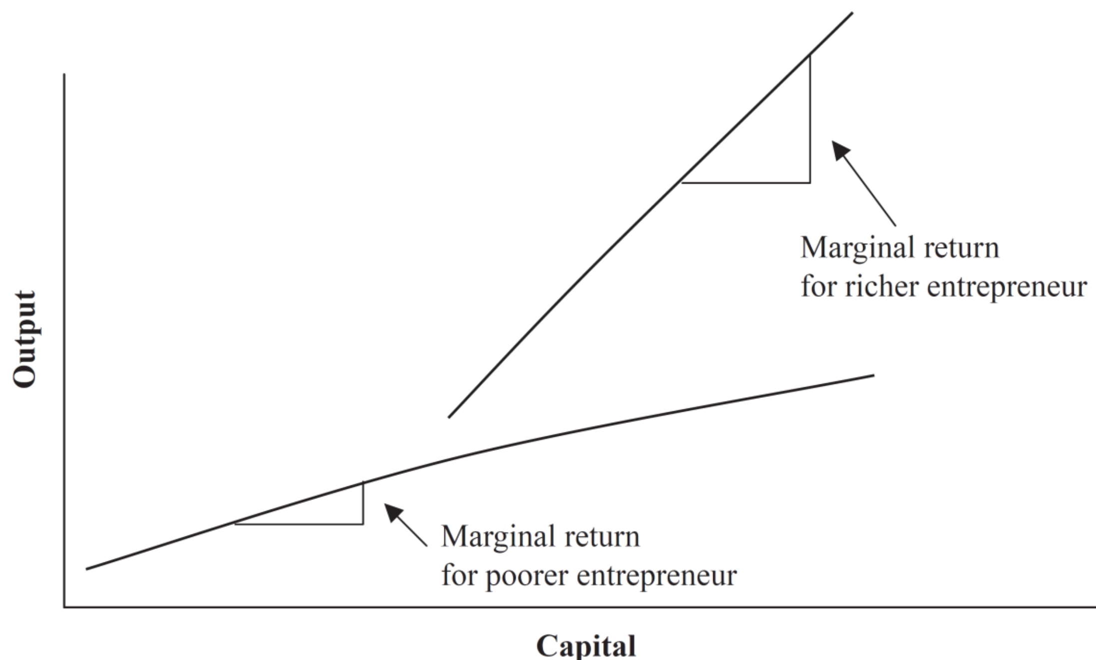
[94] This statement is a standard accessory of the EU-sponsored University Meets Microfinance training programme, see http://www.universitymeetsmicrofinance.eu/

With marginalised people definitely this is the situation (see Molnár, 2016). The poorer somebody is the flatter the production function in the capital is. Charging above market interest rates on the poor increases their marginalisation.

Figure 2. Marginal returns to capital for entrepreneurs with differing complementary inputs



Source: Armendáriz and Morduch (2010: 20)

The causes of the entrepreneurial failures of the poor

This conclusion is closely related to the second assumption. In the practice of the Kiútprogram – and I think this is a more general situation – *the most important causes of entrepreneurial failures are insufficient knowledge and lack of practice and business connections*. In this respect, the experiences of the Kiútprogram contradict the standpoint of Yunus. Initially, the programme strove to follow Yunus' model in every respect.

"From the very beginning, Grameen has gone against traditional methods of poverty alleviation by handing out cash without any attempt to first provide skills training. We have received a great deal of criticism for this policy, even from some of our friends. In Jobra we simply did not see any need for formal training, and our experience in the 1980s gave us more confidence that we had taken the right approach. … I firmly believe that all human beings have an innate skill. I call it the survival skill. The fact that the poor are alive is clear proof of their ability. They do not need us to teach them how to survive; they already know how to do this." (Yunus, 1990: 140)

Yunus' argument regarding the survival skills of the poor are clearly true; it can safely be assumed that if the average person had to move to a segregated Roma settlement in North-Eastern Hungary in mid-winter, it would be quite improbable that they could survive it in

good health. *However, surviving, managing poverty and breaking out of it demand very different skills and knowledge.* During the implementation of the programme, it became obvious that training of the clients would be crucial within the framework of the programme, especially in finance and business skills. Complicated administrative regulations, invoicing, various interactions with the bank and other official business tasks all require systematic, well-prepared training. Regarding business skills, marketing is an especially important area. Without knowledge transfer, the micro businesses created with the help of the loan can only reproduce the existing poverty, with some partial effects at best. I have doubts whether Yunus' opinion is really valid for the poor of developing countries, but it is evidently false in the case of the marginalised population of a relatively developed country.

I cite an expressive example from the practice of the Kiútprogram's cucumber growing project (see Molnár, 2015b). Although the majority of the clients, who live in small villages, often work as seasonal or day workers during the harvest, they do not fully understand the whole production process and are not well acquainted with modern agricultural technologies. They have to be taught. Typically, two things are especially difficult to understand for the beginners, who work for their own for the first time. Firstly, they have to understand that an excessive use of fertilisers is harmful. This is difficult because initially using a lot of fertiliser seems to enhance the plants' growth. Secondly, they have to understand and learn the technique of removing the tendrils: the yield will be better if some of the new sprouts are removed.

All this means that the second assumption, at least in the case of marginalised groups in a relatively developed country, is false; the main causes of their entrepreneurial failures are the lack of necessary knowledge, skills and connections. However, a treatment based on a wrong diagnosis can be harmful.

What do clients know about each other?

It is a realistic assumption that people living in close proximity can judge each other's capabilities. With character assessment, however, the possibility of misjudgement is more distinct, especially because there is no prior knowledge of what happens if somebody – in the form of unsecured loans – gets a relatively large amount of money.

Let us suppose first that the third assumption is fully satisfied. The relatively less marginalised, less undereducated people are usually less affected by the lack of necessary knowledge, skills and connections, consequently they are safer borrowers than the extremely marginalised ones. Following the reasoning of the previous section, we get that group lending leads to the formation of socially homogeneous groups. In the practice of commercialised micro-lending only the better-off groups are served. Although, according to the traditional banking practice, they are non-bankable, frequently they cannot be considered poor either by standard measures. This phenomenon is described as *mission drift* in the literature (Armendáriz and Morduch, 2010:239). However, the consequences of the fact that the methodology of group lending creates conflicts of interest within the marginalised population are much more serious. *Instead of fostering economic and social integration of the marginalised population, group lending promotes segregation and internal conflicts within the marginalised. The incentives created by group lending drive the less poor to displace their poorer peers, taking away the possibility of any collective action.*

It is interesting to observe the terminology again. Generalising the categories of "safe" and "risky" borrowers, frequently just "good" and "bad" borrowers/groups are used in the literature (e.g. Armendáriz and Morduch, 2010; Chowdhury, 2007; Varian, 1990). This is how – not consciously at all – the poor become "bad"; the lack of capabilities is interpreted as a moral issue, showing the strong effects of cognitive frames.

Now, let us investigate the other possibility, when the group members misjudge one of their peers, who eventually runs away with the loan and social sanctions are not applied or are not effective. This assumption is not improbable at all. I illustrate it by means of an interview with a client of the Kiútprogram. This client is a role model for most people in the local Roma community; he is the best producer. "I tell you that I trusted the people who tricked me most. We used to be good friends. They would not have done it to me. And as to the folks I did not trust, this is what I discussed with R. [the field worker], I knew they would cheat. Those were the first to repay the loan." The level of identification with the programme is shown by the fact that this client felt that the clients who cheated the Kiútprogram also cheated him. Still, he misjudged two families, people whom he had known since childhood.

According to the group lending model this client should have been excluded from the continuation of the programme. In addition to being unjust, such a measure would have destroyed the credibility of the programme in the eyes of the Roma in the village. In this way, *enforcing the rules of group lending would contradict the aim of poverty alleviation*.

Application of social sanctions

Up to now, like the majority of the related literature, we have investigated the question of social sanctions in micro-lending from the perspective of the lender. From the perspective of the borrower however the essence of this model is the punishment (or threat of punishment) of somebody for the fault of somebody else. Set aside for a moment the ethical concerns about the principle of collective punishment. The implementation of group lending "can lead to forms of borrower discipline which are unnecessarily exclusionary, and which can contradict the broader (social) aims of solidarity group lending" (Montgomery, 1996:289). Montgomery's conclusion is based on the experiences with a microcredit organisation in Bangladesh. He mentions stories of the acquisition of different assets of defaulting members. Sometimes, as in the case of informal moneylenders, extra-economic coercion is used to enforce repayment (Gosh, 2013).

Obviously, borrowers in a relatively more stable social position are quite capable of applying social sanctions to the others. Peer pressure can be applied only against the poorer and more vulnerable members of the local community. *Instead of empowering them, group lending can even increase the vulnerability of the most marginalised. The method of social collateral contradicts the principle of free and sustainable agency.*

5.5 Alternatives to group lending

The main objection against group lending is that the application of social sanctions can intensify the social exclusion of the most vulnerable. The loss of social collateral increases

marginalisation. In addition to this, there are situations when group lending does not work, including the following, which have happened in the practice of the Kiútprogram, too:

- risk averse potential clients don't want to take the additional risk stemming from group lending;
- nobody undertakes to lead the group;
- because of seasonality in many activities, especially in agricultural production, sequential lending is not applicable;
- in urban environments the borrowers do not know each other, they have no devices to apply social sanctions;
- in small villages almost everyone is related to one another, the danger of collusion is very high.

In the first years, the leaders of the Kiútprogram sought to follow the method of social collateral. Group formation proved to be a useful tool that was helpful in the client selection and training phases but the gradual loan issuing and peer pressure did not work, or its consequent application would have destroyed the empowerment and community building effects of the programme.

Starting from the experiences of group lending, several alternative techniques have evolved to manage the situations when the method of social collaterals is not applicable. The two most important methods are *threatening to stop lending* and *progressive lending*. Based on Armendáriz and Morduch (2010) I summarize these methods and supplement them with the techniques developed by the Kiútprogram.

Threatening to stop lending and progressive lending

The pivotal difference between threatening to stop lending and contingent renewal in group lending is that in the former case lending is stopped only in the case of the client's *own default* and not of the others. This procedure can only be used if the continuation of the business demands further investments the following year and the borrower has no sources to finance them. (One important cause of the microfinance meltdowns mentioned in the introduction was the proliferation of microfinance organisations. Threatening to stop lending was not effective because next time the clients could borrow from another organisation.)

We investigate again the problem of ex-post moral hazard. Let us assume that there are two periods of production (the calculation is similar if there are more than two periods). The revenue of 1 unit investment is y, the gross amount to be repaid is r, and the discount factor is δ. If the borrower decides to meet his or her first-period debt service (since there are no negative consequences of non-repayment in the second period we suppose that s/he does not pay back) his or her payoff will be $y + \delta y - r$. In case of non-repayment the total payoff is y. The borrower will repay if

$$y + \delta y - r \geq y \qquad (3)$$

holds, that is if $r \leq \delta y$. This construction is workable only if the borrowers trust the bank. If they think that the bank will not finance their future investments, the probability of wilful default increases. Rumours about financial problems of a microcredit organisation – even if

these rumours are not established – can destroy the trust in it, and can lead to a real meltdown (for examples see e.g. Banerjee and Duflo, 2011).

Progressive lending can be seen as a development of the previous method. In this case, the available loans increase in time. One form of progressive lending is testing the borrowers with small starting loans. The disadvantage of this kind of testing is that too small loans are usually not sufficient to start a profitable business. If the growth factor of the loans is $\lambda > 1$, then the previous $r \leq \delta y$ condition can be modified to $r \leq \lambda\delta y$.

The dynamic incentive model of the Kiútprogram

The dynamic incentive model is applied in the Kiútprogram's cucumber growing project. The aim of the programme is to promote economic and social inclusion of long term unemployed Roma people living in an underdeveloped rural area of Hungary. Unlike classical microcredit programmes, in this model Kiútprogram offers the opportunity to join a given production system. Apart from loans, the programme provides financial and professional trainings, agricultural consultancy, help in the administration and building of business connections free of charge. This support is supplied by well-trained field workers who are continuously present at the location. (For further details, see Molnár, 2015b and 2016.)

When the programme is launched in a new village the first clients belong to two very different groups, the risk averse majority usually waits for the results of the first season:

1. Very committed and strongly motivated people with low level of risk aversion who try to take any opportunity to improve the situation of their families.

2. People attracted by the loan; they believe that it is an easily obtainable resource and they do not intend to pay it back.

For the reasons explained above, using social collaterals would contradict the aim of empowerment of marginalised people and would eliminate the positive effects of trust between the committed clients and the programme. This method is a disguised version of threatening to stop lending.

Within the defaulters, we must differentiate between those who failed in their business and those who intentionally did not pay back their loans. The continuous presence of the field workers makes this differentiation possible. Failure should not be punished because it would strengthen learned helplessness[95] not only in the case of the specific client, but in the whole local community as well. Those who intentionally do not repay are excluded from the further services of the programme.

However, the main assumption of threatening to stop lending does not hold: the continuation of the production does not demand further investments the following year. Termination of lending is substituted by termination of trainings and consultancy. The next difficulty is that in the first year the importance of these services is undervalued by the potential clients.

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[95] About the problem of learned helplessness in this context see Molnár (2016).

It becomes clear only in the following year that without the assistance of the programme the production is not viable, because further learning and practice would be needed. It usually requires more than one year to become independent of the programme. Only after the second year will it become obvious to the others, who follow the results of their neighbours, that the additional income of the cooperating clients exceeds the income of the intentionally defaulting ones in the long run. This is a long-term, multi-periodic social educational process showing that there is a trade-off between empowering the poor, improving social integration and the repayment rate. The method increases the costs of the programme, but it provides better results in poverty alleviation.

5.6 Conclusions

Group lending "is by far the most celebrated microfinance innovation, and with good reason. Group lending showed how unconventional contracts can work where tried-and-true banking practices failed" (Armendáriz and Morduch, 2010). Group lending, based on the method of social collaterals, bears all the features of social innovation. It is clear that micro-lending is a useful financial product, it "demonstrated that, despite the difficulties, it is possible to lend to the poor" (Banerjee and Duflo, 2011:181). However, its promise of radical improvement of the situation of the poor is not fulfilled.

In this study, I have analysed the effects of group lending to marginalised social groups in a relatively developed country. Analysing the workings of group lending I have identified four crucial assumptions of commercial microcredit:

- The production function is concave in the capital; the marginal return to capital is relatively higher for the poorer than for the richer entrepreneurs.
- The main causes of the entrepreneurial failures of the poor are the following: riskiness of the selected enterprise, lack of sufficient effort and strategic default.
- Potential clients exactly know each other's type, or they can get to know it at relatively small costs.
- Group members can efficiently impose social or economic sanctions upon each other in order to enforce intensive work and repayment.

In this paper I argued that the first two assumptions are not valid. The poorer somebody is the flatter the production function in the capital is. Charging above market interest rates on the poor – which is a general practice in micro-lending – increases their marginalisation. The most important causes of entrepreneurial failures of the poor are the lack of necessary knowledge, skills and connections.

In most cases, the third and fourth assumptions are valid, but their enforcement contradicts the aim of poverty alleviation. Instead of fostering economic and social integration of the marginalised population group lending promotes segregation and internal conflicts within the marginalised. The incentives created by group lending drive the less poor to displace their poorer peers, taking away the possibility of any collective action. The method of social collateral contradicts the principle of free and sustainable agency.

The study presents a multi-periodic, dynamic incentive lending model, which is a transformed version of the threatening to stop lending model. The method increases the costs of the programme, but it provides better results in poverty alleviation and in promoting social integration of the most marginalised people.

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Creating Economic Space for Social Innovation

The CRESSI project explores the economic underpinnings of social innovation with
a particular focus on how policy and practice can enhance the lives of the most marginalized and disempowered citizens in society.

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