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Andrzej Rapaczynski

Abstract

Impact investment is attractive to many because it seems to combine support for progressive causes with an apparent commitment to the principles of a market economy. In fact, however, a rational impact investor is not simply creating demand for certain types of corporate actions; he/she is attempting to use corporate governance mechanisms to influence fiduciary decisions of the management. The cost of this tactic for the health of the capitalist economy is potentially very considerable. The American capitalist system relies heavily on a relatively fragile corporate governance arrangement in which the agency problems of a modern corporation are minimized by making shareholder value into the ultimate objective of the management. A crucial assumption in this model is that shareholders are a homogenous group interested in the maximization of financial returns, which makes market price into a reliable criterion of corporate performance. The injection of a more complex corporate objective function – an inevitable consequence of impact investment – raises the potentially insoluble problem of aggregating the diverse interests of the shareholders and seriously weakens the ability of the shareholders to monitor management performance.

Impact investing is an ambiguous idea that may mean different things to different people. So let me begin with a few words of clarification and an attempt to specify the particular aspect of impact investing that I would like to address.

There is a certain immediate attractiveness associated with the very idea of impact investing. The objectives of many impact investors are in some ways similar to those of many critics of capitalist market societies: both groups want to contribute to the protection of the environment, support clean technologies and sustainable agriculture, help provide housing, education, and medical assistance to the poor, improve the treatment of workers or other underprivileged groups around the world, and generally enhance the values that the market otherwise does not seem to provide in sufficient quantities by itself. But unlike anti-capitalist political activism, which is based on the beliefs that markets are inherently flawed and that the values endangered by the capitalist economy should be achieved by political compulsion, impact investing looks like a classic affirmation of the market: by putting his money where his mouth is, an impact investor may be seen as creating demand for socially beneficial corporate actions, and the essence of capitalism is to satisfy such spending-backed demand.

In fact, however, impact investing is nothing of the sort. There are, of course, many kinds of people engaging in something like impact investing, and not all of them are of interest here. Some impact investors may be firm supporters of market capitalism and simply not know how it functions, or they may be acting under various illusions about how their actions will do good at no extra cost. Others may just feel good by giving essentially charitable support for socially conscious corporate action and believe that the social cost of such actions, if any, will be covered by their own lower returns. Still others, such as foundations or universities, are investing institutional money under pressure from their non-investment constituencies, such as students, professors, and others who are expressing their ideological preferences, because the legitimacy of the leaders of those institutions depends more on the opinions of their internal constituencies than on actual investment returns. Finally, some impact investors might be financial intermediaries that use the social appeal of impact investment to attract capital to their funds, either trying to persuade the investors that they can indulge in their ideological preferences without sacrificing their financial returns or leaving the issue hazy enough to allow for the same illusion.

What interests me here is what a *rational* investor, who is not a philanthropist, might be trying to accomplish by impact investment, rather than what a deluded or misguided social activist may imagine he is doing. I want to inquire into what such a rational impact investor can in fact realistically hope to accomplish, the conditions under which he may succeed in advancing the social objectives he pursues, and what may be the real social cost of his activities, especially in terms of the functioning of the economic system. At bottom, then, I want to examine whether impact investing can be seen as compatible with the basic framework of a capitalist market society.

The *differentia specifica* of impact investment, as I understand it here, is the acceptance of non-financial standards as an integral component of measuring corporate performance. I don't mean, of course, that an impact investor ignores financial returns. What is important is that she does not see social impact as something that will simply improve financial returns in the end. Indeed, an investor who buys the shares of a company that pursues a certain social policy, be it otherwise desirable or not, because she believes that it will at some point increase her financial return, is in fact just an investor *tout court*, and not an "impact" investor at all. The special feature of an impact investor is that she sees the social impact as an *independent factor* in evaluating corporate performance, to be weighed *together* with financial returns, even if as a result the standard financial return on investment ultimately ends up smaller than it would otherwise have been.

This definition of impact investing is not by itself incompatible with the values of a market society. Capitalism does not mean that all goods are traded on the market or that all values are best measured in money. The fact that people adhere to such things as loyalty, and so are not ready to sell their attachments to friends or spouses, clearly makes society better, and no more detracts from the advantages of the markets in general than does the fact that bumping off one's competitors, even if it could be very profitable on a company level, is barred by law – and the reason why it is so barred is *not* to enhance the overall GDP (though it may have this effect as well), but at least in part to enhance human dignity, which is not traded on the market, and the value of which is not properly measured in monetary terms.[1] Indeed, there has been a growing sense among many economists that overall social welfare cannot be measured in financial terms alone, and that the traditional GDP measures should be revised to include such "non-financial" factors as happiness, clean environment, respect for human rights, etc.[2]

What is of primary importance, however, and what puts impact investment in a different class of phenomena than not having a price on one's loyalty to friends or restricting the freedom of market participants to bump off their competitors, is the fact that impact investing, at least as I understand it here, goes beyond imposing external, political constraints on corporate behavior, or imposing personal (perhaps morally motivated) restrictions on the stocks in which one is prepared to invest. Instead, the impact investing with which I am primarily concerned here focuses on influencing the internal decision making processes of the companies in the investor's portfolio and is designed to give *positive support* to certain kinds of company actions, so that in weighing their social impact together with financial returns, the investor is in fact doing more than just potentially sacrificing a portion of his own return in exchange for the satisfaction of some other objectives. He is also intent on providing an incentive (perhaps, though not necessarily, a financial one) to company decision-makers to

[1] To be sure, if a given value, such as personal loyalty, comes into conflict with some economic values—say, the efficiency of a system of justice involving compulsion to testify against one's friends or spouses—tradeoffs may in the end be necessary. Some believe that this amounts to "putting a price" on loyalty. I acknowledge the seriousness of this problem, but do not deal with it here.

[2] Perhaps the best known effort to redefine the measure of societal well-being is the2008 report commissioned by President Nicholas Sarkozy of France and published as *Report by the Commission on the Measurement of Economic Performance and Social Progress*, http://www.insee.fr/fr/publications-et-services/dossiers_web/stiglitz/doc-commission/RAPPORT_anglais.pdf. To be sure, how the various components of societal well-being are weighed against each other in any measure alternative to GDP is a big and controversial question.

pursue the investor's preferred social objectives—ones that the same decision-makers would not be otherwise pursuing (at least not to the same extent).

Now my main claim is that impact investors of this kind are not really – or at least not "just" – investors. Insofar as they are not predicting that the market will move in their direction – but rather want to move the fiduciary corporate decision makers in the direction of certain socially conscious decisions, even at a sacrifice of financial return – they are in fact in a different kind of business: that of *corporate lobbying*, rather than investing.[3] Like a takeover artist who invests in a company in order to put himself in a position to influence managerial decisions, impact investors also want to use their money as a means to influence fiduciary corporate decision makers, but unlike most takeover artists, who just want to enhance the value of their stock, they do it to maximize certain interests which the impact investor, but not the other investors in the same company, values above the market. Indeed, as I shall argue, an impact investor is "bribing" the corporate decision makers to use other investors' money to foster the impact investor's own preferred social objectives.

A few further words of clarification are required, lest it be thought that I am proposing some sort of purist, perhaps "ideological," theory of investment. I do believe that buying stocks is not like buying cars: although consumers may have some affection for certain car colors, or even just for the "make" of a car (the fact that it is produced by a certain company), stock investors (or creditors) are not usually satisfying personal "tastes" of this kind; they are not maximizing preferences other than a desire for the highest financial returns, although it may well be very long-term returns. Indeed, stocks are not consumer goods at all, and buying them because one "likes" the company involved is like having a preference for two five-dollar bills over one ten-dollar bill because one prefers Lincoln to Hamilton.[4]

"Wait a minute!" a reader may exclaim at this point. Impact investors are not pursuing their own private interests by putting pressure on company management; they are acting in the *public* interest, perhaps trying to prevent company management from making decisions that may generate some financial returns, but are socially harmful or unethical. Take, for example, a company like McDonald's, whose purchasing policy supports breeders engaging in inhuman and unethical treatment of animals. What's wrong with trying to persuade McDonald's major investors to put pressure on the management to change their policies?[5]

[3] I am making a distinction here between "corporate" and "political" lobbying because addressing corporate decision makers with demands to foster public goods has different, and potentially more serious, side effects than addressing the same kinds of demands to political leaders.

[4] I do not mean to deny, of course, that shareholder *loyalty*, much as a customer's, is not only not always irrational, but may in fact be very valuable to the company involved. This kind of shareholder loyalty is not a "taste" for a particular company, however, but a form of trust in its management's honesty and ability, which may overcome, at least for a while, a less positive evaluation by the market. For a classic analysis of this subject, see A.O. Hirschman, *Exit Voice and Loyalty. Responses to Decline in Firms, Organizations, and States* (Harvard U. Press, 1970).

[5] I picked the McDonald's example from Wayne Pacelle's *The Humane Economy: How Innovators and Enlightened Consumers Are Transforming the Lives of Animals* (Harper Collins, New York, 2016). Pacelle in fact tells the story of enlisting the assistance of one of the most famous shareholder activists, Carl Icahn, to help influence McDonald's management. *Ibid.*,pp. 33-38. In his May 2016 NYRB review of Pacelle's book, Peter Singer makes essentially the same argument as the one I cite in the text: "CEOs tend to listen to a billionaire activist

What's wrong is that the management of McDonald's is not the right addressee of such ethical desiderata. To the extent that McDonald's is about to make more money by being ethical, the management can be talked to in terms of business matters, not ethics, and no "impact" investor is necessary to make the point that they should modify their purchasing policies. To the extent that McDonald's (and thus its non-impact investors) is about to lose money on changing its policies, however, the impact investor should either address himself to the state and ask it to impose more humane policies on both McDonald's and its competitors (thus forcing the public to pay the higher price for the "ethical" meat), or appeal directly to the consumers to refuse to buy "unethically" produced hamburgers, which might create a standard, and perfectly legitimate, market pressure on McDonald's to change its policies. But to buy the stock of McDonald's in order to lower its financial return and achieve other objectives is a potentially dangerous proposition.[6]

It is not simply a fact concerning human "tastes" that distinguishes investors from ordinary consumers. That investors in a company, unlike the consumers of its products, have essentially *identical* interests is a very important *systemic presupposition* of American corporate law; indeed, a basic assumption of the American capitalist system in general. Without it, the collective action and agency problems of a modern corporation would be much worse than they already are: the very interests of corporate principals would likely be an aggregate of irreconcilable special objectives and, even if a complex system of aggregating their diverse preferences were available (which may not be the case), the principals would still have much greater difficulty monitoring the managers who are in control of their company's day-to-day decisions.

At bottom, we are dealing here with the traditional distinction between markets and other forms of coordinating human behavior, involving all kinds of organizations with various *governance* mechanisms such as voting, hierarchies, etc. Indeed, the very institution of a corporation is but a network of contracts that replaces market transactions among a number of individual input producers with an organizational structure, involving both voting and hierarchies, that endures across a large number of transactions and results in a non-market

investor with a history of buying enough stock to get board seats and then make changes to management. Icahn had done that to make money for himself and his investors. What was to prevent him doing it to reduce animal suffering?" The answer to Singer's question is that in causing McDonald's to reduce animal suffering, Icahn would not have been "making money for himself and his investors." What he would likely be doing would be causing other investors in McDonald's (but also himself and his investors) to lose their money. (I say "would" because Icahn, at least in Pacelle's account, simply advised Pacelle to run for McDonald's board and used his personal authority to facilitate contact with McDonald's management, but did not in fact invest in the company to get a seat on the board, or another corporate governance position in order to change McDonald's behavior.)

[6] As noted already, I am not arguing primarily against people who don't buy McDonald's stock because they object to some aspects of McDonald's policies or activities. What concerns me is not simple avoidance of associating oneself with something of which an investor may personally disapprove, but an investment strategy designed to effect a change in corporate policies through the exercise of the power over management that the corporate governance system grants to shareholders. To be sure, the difference between such "negative" and "positive" impact investment may sometimes be hard to draw (as when a large-scale boycott of a company's stock may lower of the value of its shares and effect a change in corporate decisions).

coordination of individual behaviors. This allows the corporation to act as a single economic agent in the broader economic market.

But precisely because of this, in the absence of special contractual arrangements, ownership of a corporation is composed of essentially *undifferentiated share*s of all investors who constitute together one collective entity and, unless their interests are sufficiently aligned, face the classical "collective action" problems: since any corporate costs are shared identically among all the shareholders (in proportion to their investment), if some principals value a certain benefit while others do not, a corporate pursuit of that benefit will allow some principals to obtain it while imposing a part of the cost on the others. This kind of free riding is a potentially serious problem that, unless overcome or seriously mitigated, threatens to undermine the effectiveness of the corporate structure – especially in a world of widely dispersed ownership.[7]

To be sure, corporations, and the legal-regulatory environment in which they operate, have developed all kinds of mechanisms to deal with the collective action problems of corporate principals, and this is what much of corporate governance is about. A whole host of corporate charter provisions, as well as various mandatory disclosure rules, keep shareholders informed about corporate matters, while voting rules and other governance mechanisms offer them the means to influence corporate decisions. It may therefore be hoped that these mechanisms provide a consistent method of aggregating the various objectives of the principals, and avoid, or at least mitigate, most instances of free-riding and other forms of exploitation.

It would be fatuous, however, to rely exclusively, or even predominantly, on the disclosure and voice-enabling aspects of corporate governance to mitigate the possibility of the exploitation of most shareholders in the world of extremely dispersed corporate ownership that is characteristic of the U.S. economy.

I set aside the somewhat academic problem of the Arrow-theorem-type impossibility of consistently aggregating the potentially extremely diverse preferences of such a heterogeneous group as the shareholders of an average American corporation, comprising people of all classes, backgrounds, occupations, interests, political commitments, etc.[8] But quite independently of this, the majority of American shareholders own a diversified portfolio, composed of small stakes in many individual companies, and they are not expected to have an interest in devoting significant resources to direct participation in corporate governance. To be sure, it is possible to imagine some other arrangements giving the average small shareholder an indirect or "virtual" representation, and not requiring an unreasonable investment of time and energy that active involvement in corporate governance entails. Some form of delegation, such as the bank-managed trust accounts common in Germany, or some other method of aligning small stakeholders' interests with those of a larger, more active investor, could perhaps mitigate some of these problems. But the price to be paid for such a system is likely to be also high: above all, the resulting high ownership concentration, prevailing in

[7] For *the* classic analysis of collective action problems, see M. Olson Jr., *The Logic of Collective Action. Public Goods and the Theory of Group*s (Harvard U. Press, 1965; 2nd revised edition, 1971).

[8] Cf. K.J. Arrow, *Social Choice and Individual Values* (J. Wiley, 1951; 2nd ed., Yale U. Press, 1963).

the environments in which shareholder activism is the norm, is likely to pose a significant obstacle to the maintenance of a vibrant financial market. Indeed, it is widely thought that this price is too high to make shareholder activism into a realistic option for most American corporations. The idea that the overwhelming majority of shareholders are simply interested in maximizing financial returns on their investment, and do not have other seriously diversified interests that would have to be reconciled and aggregated on individual company level, is a very important presupposition of American corporate governance, in the absence of which the whole financial-market-based corporate system might have to be rethought.

It could be said at this point that financial markets, just like product markets, provide a simple answer to most of these collective action problems by substituting an investor's exit option for the intricacies of the exercise of voice in an attempt to make corporate decisions better suited to the buyer's preferences. Just as I do not have to try change the way Ford builds its cars in order to maximize the satisfaction of my preferences (because I can simply buy a car from GM or another firm that offers an alternative better suited to my tastes), every stock investor is also free not to buy the shares of any particular company, or even to exit from any investment by selling his shares on the open market in order to make sure that his portfolio best matches his investment objectives. So, it may be said that impact investors who care about, say, the environment will invest in firms that include this among the objectives they pursue, even at the cost of some financial returns, while purely financial investors will stay away from those companies, and invest in firms that cater to their financial objectives. True, financial markets may be somewhat less flexible than product markets because, while Ford can produce a number of different car models in order to cater to a diversified body of consumers, it is much harder (in fact, in most cases, not realistic) to produce different kinds of equity stakes in the same company in order to cater to investors with qualitatively different investment objectives.[9] But even if each company is in fact offering only a single equity "product" on the market, companies can specialize, and the power of the market can perhaps be harnessed for the enhancement of important social values and a greater achievement of socially desirable objectives.

But the crucial corporate-governance role of the financial markets in the American economic system is not limited to substituting exit for voice as a means by which a shareholder signifies his or her disapproval of corporate policies. Indeed, the most fundamental governance function of the financial markets lies in their ability to lower radically the information costs necessary for the shareholders to monitor corporate performance.

As long as the ownership and management are separated, as they are in most modern American corporations, monitoring the performance of the management is probably the most serious problem of corporate governance in general. Indeed, even in a corporation

[9] To the extent that it is possible to offer various kinds of equity stakes, the differences in investment objectives that can be accommodated in this way are mostly limited to such things as risk or liquidity preferences of different investors. Because of the public-good nature of most impact investment objectives, it is extremely unlikely that an ownership structure could be devised in which some investors, who are in part rewarded with, say, a cleaner environment, have to forego some monetary returns or other rewards of their investment.

with very concentrated ownership, in which there exists at least one shareholder whose stake is large enough to give him a sufficient incentive to monitor management performance, the "agency problem" of a modern corporation does not cease to exist, because the main purpose of the separation of ownership and control is to match the owners of capital who lack managerial and entrepreneurial skills (or even a proper understanding of what such skills consist of), with the people who have those skills, but are not wealthy enough to provide the capital necessary for deploying them to the optimal effect. The separation of ownership and control thus allows the owners of capital, who are interested in earning more than just interest on their money, to avail themselves of the "upside" that may be gained from the special entrepreneurial, managerial, and technical skills for which the people who manage businesses are chosen through a specialized managerial labor market.

This matching of capital and managerial skills is perhaps the greatest "secret" of a successful corporate system. The reason why it is a "secret" is because managerial skills, especially insofar as they entail what we think of as innovation and entrepreneurship, are quintessentially "ineffable."[10] Like most important ways of doing things, from knowing how to ski to being a great writer or painter, management is not a "science" that follows a set of prescribed rules. (Indeed, being a good scientist is itself not a science.) To be sure, there are ski schools, writers' workshops, and business schools. But if all it took to be an Olympic skier was to follow faithfully the rules learned in ski school, the very idea of the Olympics would make no sense. And what is true of skiing is even more true of entrepreneurial management. Indeed, the essence of entrepreneurial skill is the ability to see that what the standard knowledge and wisdom prescribe is sometimes *not* the best way of proceeding in a particular case, and the ability of an entrepreneur to succeed is the most important (and the most "mysterious") in those cases in which nearly everyone else sees only an excessive risk of failure.

The very nature of good (innovative and entrepreneurial) management is what makes it so hard to harness for the benefit of investors. On the one hand, investors want to benefit from the mysterious skills possessed by the wizards of the industry, but, on the other hand, precisely because those skills are in an important way "mysterious," monitoring management has the features of a paradox. If you want *ex ante* to limit what the management can do with your money, you will cripple its ability to do the very innovative things that are likely to appear *ex ante* unreasonable, but which might turn out later to have been the foundation of superior returns. Also, because managerial decisions involve risks, many good managerial decisions may, even *ex post*, look wrong just because they did not pan out, although the risk taken had been in fact justified in the first place. So *managerial discretion* is the key if you want to benefit from the skills that the manager has, but you don't (and don't

[10] The importance of "ineffable knowledge" was stressed in M. Polanyi's *Personal Knowledge* (U. Chicago Press, 1962). But that management is an "art," and not a "science," had been stressed by F.H. Knight as early as 1923. See "Business Management: Science or Art?" *Journal of Business,* State University of Iowa, Vol. 4., reprinted in R.B. Emmet (ed.), *Frank H. Knight in Iowa City*, 1919-*1928*, Research in the History of Economic Thought and Methodology, Volume 29-B (Emerald Group Publishers Ltd, 2-11), pp. 49-54.

even fully understand). Still, if you leave the management too much discretion, then how are you going to prevent not only bad business decisions, but also self-interested behavior that diverts corporate benefits to the managers in control?

This paradox of management-performance monitoring affects even large or controlling shareholders, who have all the incentives to expend enough time and resources to become informed about most corporate decisions. Even such shareholders are likely to stifle innovation and lower corporate returns, unless they leave the management enough discretion to enable it to act against conventional wisdom. But unless the controlling investors find some way to curtail self-serving managerial behavior, they also risk, indeed probably assure, that the management will not faithfully serve their interests, sub-optimally perform, and not give the shareholders their due.[11]

The agency problem of a firm without controlling shareholders or other large investors is even more serious, as the shareholders lack not only the skills, but also the incentives, to learn about the technical details of complex corporate decisions and to monitor the management in order to assure that it maximizes the interests of the shareholders and does not divert corporate assets to other purposes. And it is here that well-functioning financial markets solve the "mystery" of the modern corporation: by focusing on the goal of maximizing financial returns, thus encapsulating all the best available knowledge about the quality and honesty of the management into a single piece of data – the stock price – they provide a uniquely simple, yet comprehensive and maximally accurate, measure of corporate performance.

This, then, is my main corporate governance point: One of the foundations of capitalist success is the institution of modern corporation which matches capital and entrepreneurial managerial skills with the help of a governance arrangement that gives very extensive discretion to the management, while at the same time enabling even unsophisticated investors to monitor management performance by using a simple proxy of the stock price, which provides a common denominator of the extremely complex and heterogeneous managerial decisions that are otherwise very hard to monitor, even at a very high cost that most investors do not have the incentives or resources to commit.

But the corporate governance arrangement of this kind crucially presupposes that price is indeed the common denominator of all investors' objectives, and that return maximization can be seen as the distinctive and unifying aim of all shareholders. This is, of course, a strong assumption, affected with a certain degree of normativity. What I mean by this is that shareholders, as actual individuals, may, as a matter of fact, have all kinds of non-financial preferences with respect to desirable corporate behavior, and that markets may not be not be able to satisfy some of them to the extent that various, perhaps even all,

[11] One may be tempted to argue at this point that the paradox of monitoring managerial performance calls for a solution involving *trust* between the owners and the managers. I think that there is an element of truth in this, and good business people have always insisted on the importance of honesty and trust in commercial affairs. But trust alone is also very unlikely to provide a sufficient solution to the agency problems of the modern corporation with a widely dispersed ownership by many mostly small investors. A systemic solution, assuring a high degree of *incentive compatibility*, rather than appropriate socialization of the actors involved, is therefore necessary to deal effectively with the agency problems in a modern economy.

shareholders may like. To the extent that markets are not perfect, there may be many potentially worthy (as well as nefarious) objectives of this kind. But what I am arguing here is that while some such objectives may be properly pursued through the political system, the fact that the market does not price them correctly is the reason why their injection into the ordinary mechanisms of corporate governance amounts to "not playing by the rules." In other words, when the simplicity of the financial-return measure of managerial performance is lost because of the inclusion of corporate aims that the market cannot properly price, the objective function of the management contains a number of heterogeneous components that are likely to be very hard, or even impossible, to aggregate. And once the management's objective function is so complex, monitoring managerial performance becomes largely a fiction. When a company's product does not sell, for example, managers can still claim overall success because they caused the company to contribute to saving the environment, maintain a happy labor force, or serve various underprivileged communities. Once stock price is no longer the standard measure of corporate performance, the difference between good and lousy management becomes muddied and agency problems become more serious. A fall in efficiency and a diversion of corporate assets is likely to follow.

In this respect, impact investors, by advocating for a complex managerial objective function, are in the same boat as the proponents of corporatist multi-constituency theories of the corporation, who also contest the idea that the maximization of shareholder-value, as expressed by the stock price, is the overriding purpose of corporate management, and argue for the inclusion of the interest of the workers and the state (or the "public") among the objectives to be pursued by the people in control. Indeed, state ownership is essentially in the same category as well, in that the struggle over the direction of corporate decisions in firms with a sufficiently large state ownership is no longer decided by the market, but depends at least in part on a contest among various political preferences and considerations. It is a rather widely recognized fact that companies do not perform optimally under such conditions, and neither do economies in which they prevail. Is there any reason to believe that widespread "impact investing" would have a different effect?

To be sure, the proponents of impact investments are not just another group of corporatists or socialist critics of capitalism. Indeed, unlike the proponents of state ownership or of the corporatist multi-constituency basis of the corporation, impact investors do not advocate a remaking of the very foundations of the capitalist market economy. In particular, they are not advocating a radical change in the very principles of corporate governance characteristic of the American capitalist society by an injection of the state or other non-shareholder groups into the corporate decision-making process.

Indeed, unlike many reformers of the capitalist system, impact investors do not even propose to achieve their objectives by addressing themselves to the political system, and they do not advocate any *external*, political (legal and regulatory) constraints on the way the corporate market operates. This may seem strange, given that the objectives of impact investment, be they clean environment, social justice, or fair labor relations, look very much like standard public goods that are suboptimally provided by the market and often require state compulsion to overcome the free-riding that causes the market to fail. In fact, if the goals of impact investors are indeed public goods, then it is quite easy to see that they are addressing themselves to the wrong forum. Persuading economic agents to contribute voluntarily to the achievement of such goods may play some role in certain situations, but it is, in most cases, roughly equivalent to arguing that refraining from polluting the air is a realistic alternative to coercive environmental regulation. So why would anyone do that instead of trying to persuade enough people to vote for regulation?

On the other hand, to the extent that the goods pursued by impact investors may *not* be public goods, why would the same people not simply buy them on the market? It may *look* like that's what impact investors are doing, and they may *say* that that's what they are doing, but that is not the case. If you want some good that the market can supply in quantities corresponding to the demand—say, polio vaccinations for children in poor countries—the natural thing to do would be to set up foundations or NGOs devoted to buying the vaccines from the existing pharmaceutical companies (and perhaps assuring that they are properly distributed to the children in need). But buying the stock of the same pharmaceutical companies would make no sense, unless you believe that through your purchase you will gain enough influence on management decisions to pressure the companies to provide the vaccines for free (or at a steep discount) and spread the cost among all the shareholders.[12] And once you are into bribing fiduciary decision-makers to pursue your own special interest at the expense of others, you are not that different from those who exploit the weakness of the political system by bribing politicians to obtain what they cannot achieve through the market.

But there is also another possibility that perhaps best embodies the special condition faced by many impact investors, and may help explain the attractiveness of the idea. Consider a group of people who advocate pursuing some genuine public good, but who want *more* of it than they can persuade other people to pursue. In other words, consider a minority of citizens who, either because they are more virtuous or because of their idiosyncratic valuations, want more of, say, clean environment than does the majority, which is necessary for a collective political decision. Now this group is indeed facing an especially difficult situation because they seem unable to satisfy their preference *either* through the political system *or* through the market, at least not as long as they are playing by the rules of these two institutions. A minority is clearly likely to lose in the political arena, unless it finds a way to block the ordinary majoritarian way in which the political decisions are usually made – this is the classic "special interest" situation that most impact investors disdain: they would rather pay for what they want than try to lobby and bribe their way around the normal political procedure. But the problem that the impact investment minority faces is that because of the peculiar public nature of the good they are trying to obtain, they are also likely to be unable

[12] To be sure, if you think you could run an existing pharmaceutical company better than its present management, it might make sense to buy a controlling stake and effect a takeover (or start a new company on your own). But unless you intend to force the rest of the shareholders into paying for something that they don't want to pay for, it is hardly an instance of *impact* investment. As long as the other shareholders are not losing money, you are simply another (though more active) investor.

to buy it on the market, even if they are willing to pay its "fair" price. Continuing with our example, the environmentally-minded minority wants an excess of clean environment over what other people demand. While the market alone may not produce enough clean environment for anyone, the quantity demanded by most people can be relatively easily obtained through the political system. But the majority will not vote to pay for the excess desired by the minority, and even if the minority wants to pay for it, the majority may react by decreasing their willingness to pay for the same good because they can free-ride on the voluntary contributions of the minority. So the minority in question is indeed a peculiar special interest. They want something that they believe is good for everyone, but others are not willing to pay for enough of it, and when the minority wants to pay for the excess by itself, it will not get it either because the majority will now reduce their effective demand, so as to keep the amount of the good in question at the lower level that would have been provided anyway.

Not an enviable situation to find oneself in. And it may very well be the peculiar difficulty of their position that makes impact investors pursue their objectives by exploiting the weaknesses and failures of the market itself. The particular weakness that gives impact investment some chance of success is, as I argued, the relatively fragile governance structure of the modern corporation, designed to solve the agency and monitoring problems of the widely dispersed shareholders, but only so long as the shareholders are a homogeneous group intent on maximizing financial returns. It is this fragility that the impact investment movement is trying to exploit by proposing that investors consider non-financial objectives of the companies in which they invest and impose a more complex objective function on the management in control of most corporate decisions. This may not appear as reprehensible as bribing politicians to devote public funds to foster your own special interest. But as I argued, the price of this move is also potentially very steep: it weakens the capitalist economic system and undermines one of its most sophisticated institutional achievements.