



How to Promote High-Impact Innovations through Social Innovation Funds

A Call for Public-Private Partnerships

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Abstract*

The purpose of this concept note is to serve as a background document for an internal discussion of the Inter-American Development Bank (IDB) about a new approach to address social problems by combining the experience and capabilities of the Bank's public and private sector windows. This document calls for the creation of the Social Innovation Fund (SIF) as an IDB country-specific program that would leverage public and private funds for the purpose of scaling up high-impact social innovation by combining citizens' ideas, governments' enabling mechanisms, and the private sector's flexibility, drive, and capital for innovation.

JEL Classifications: F34, F30, G21, I32, M13, O2, O31, O32, O38

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Introduction

Why Social Innovation?

Social problems arise when people do not have access to labor markets, products, and public services, and thus have no means to reveal their preferences and challenges, either to the market or to the government. Today there is increasing awareness and recognition that innovation and breakthrough technologies are a force to be reckoned with to solve social problems, and that capturing the opinions and preferences of the final beneficiaries is an essential component of social innovation.

How to Support Social Innovation

Public-private partnerships are essential in bringing high-impact social innovations to fruition. The **Social Innovation Fund** (SIF) would provide a private-public partnership structure created by governments with funding and support from the IDB, which would aim at maximizing taxpayer money to achieve the largest social impact by mobilizing additional resources from the private sector.

The SIF would host at least two distinct independent investment vehicles: a nonreimbursable grants vehicle fully funded with government funds (**the “Grant Social Innovation Fund”**) with the purpose of bringing to life innovations that address the needs of the poor; and a reimbursable capital vehicle (**the “Investment Social Innovation Fund”**) funded with at least 50 percent government funds which are to be leveraged to a maximum ratio of 1:1, with additional private sector funds to finance the scaling-up of social innovations through private sector participation.

The realm of social problems that could be tackled and approached through innovation is vast. The prioritization by governments of topics such as child malnutrition, improving school education, infant mortality and others is driven by the government’s social agenda. Once a topic has been identified the SIF can spark the social innovation process, which includes (1) identifying the most binding challenges with the involvement of the beneficiaries; (2) identifying the solutions with firms, entrepreneurs, and universities, among others; (3) searching for the scalable innovation; and ultimately (4) scaling the social innovation.

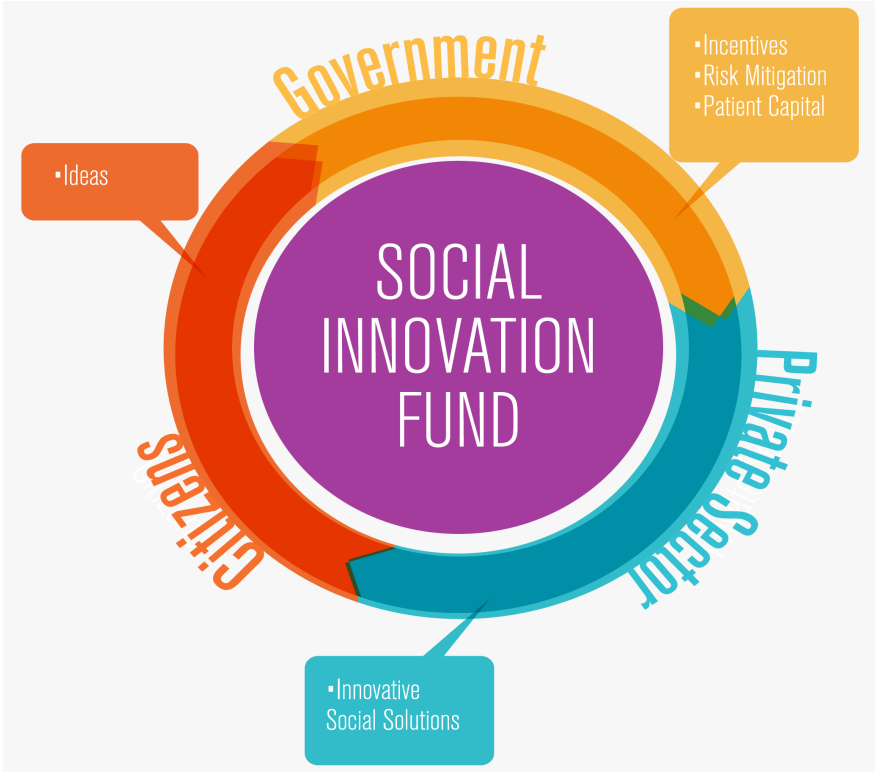
The basic principle of the Social Innovation Fund is to maximize the available public and private resources and capacities to bring innovative solutions to the lives of the poor.

Promoting High-Impact Social Innovation through Public-Private Partnerships: The Social Innovation Fund

Why Create a Social Innovation Fund?

An innovation with a high social impact is one that provides a scalable solution to a well-defined social problem. While both social policies and innovation policies (that improve the productivity of firms) have always existed in Latin America and the Caribbean, the combination of the two is unique. Why and how should we promote innovation as a tool to meet today’s social challenges?

We live in a time of technological change. New technologies, particularly communication technologies, are generating fresh ideas and innovations by integrating interdisciplinary groups that are geographically dispersed. At the same time, these technologies enable people to become informed of existing inequalities, and give those affected by the inequalities the opportunity to come together to be heard and express their frustrations and challenges, which in turn brings new pressures on governments. As a result of this, the design of social policies can no longer afford to disregard the active participation of the beneficiaries. To involve the excluded in the design of the solutions to their problems is not just possible, it is imperative.



Public-private partnerships are essential to bring high-impact social innovations to fruition. Governments are conscious that they cannot address all social challenges on their own, considering that this requires knowledge, and private sector expertise that are beyond the public sphere. Conversely, the private sector is unwilling to tackle these challenges on its own. The innovation process and R&D carried out by private companies generates social benefits that exceed the private benefit to that particular company. Since individual companies cannot fully capture all the benefits associated with creating new ideas, governments should incentivize companies and subsidize these processes.

Thus scaling a social innovation requires two key ingredients: incentives/risk mitigation and patient capital. Experience in other regions shows that partnering with private actors, both to design solutions and to finance their scalability, maximizes governments' resources to create positive social impact (Schwab Foundation for Social Entrepreneurship, 2013). As a result, high-impact social innovations can only be successfully tackled by a concerted and joint effort between the public and private sector.

The Key Element: Involve the Excluded in the Innovation Process

Social problems arise when people do not have access to labor markets, products, and public services, and thus have no means to reveal their preferences and needs, either to the market or to the government. To tackle this, the first step of any social policy must be to design tools that enable marginalized people to communicate their challenges and needs. Technology is an essential tool to facilitate and build channels of collaboration among different groups.

The Competitiveness and Innovation Division organized a "call for **problems**" in which, through an interactive website, people could communicate the issues they considered most relevant to the economic inclusion of people with disabilities. In turn, people could vote for the issues they considered most pertinent. Subsequently, the IDB organized a "call for **solutions**" that encouraged, with financial support, companies and universities to find solutions to the five top-voted problems. Through this process, the IDB provided beneficiaries with the means to jump from the periphery to the center of the innovation process by giving voice to their knowledge and perspectives and providing them the space to communicate their most urgent challenges.¹

The mechanism of creating a contest for problems and solutions is an effective means to generate social innovation, primarily because low-cost technologies such as websites or cell phones can generate knowledge between geographically and socially dispersed groups (e.g., crowdsourcing), allowing beneficiaries, universities, and businesses to turn a problem into an idea, which consequently becomes the key to the solution.

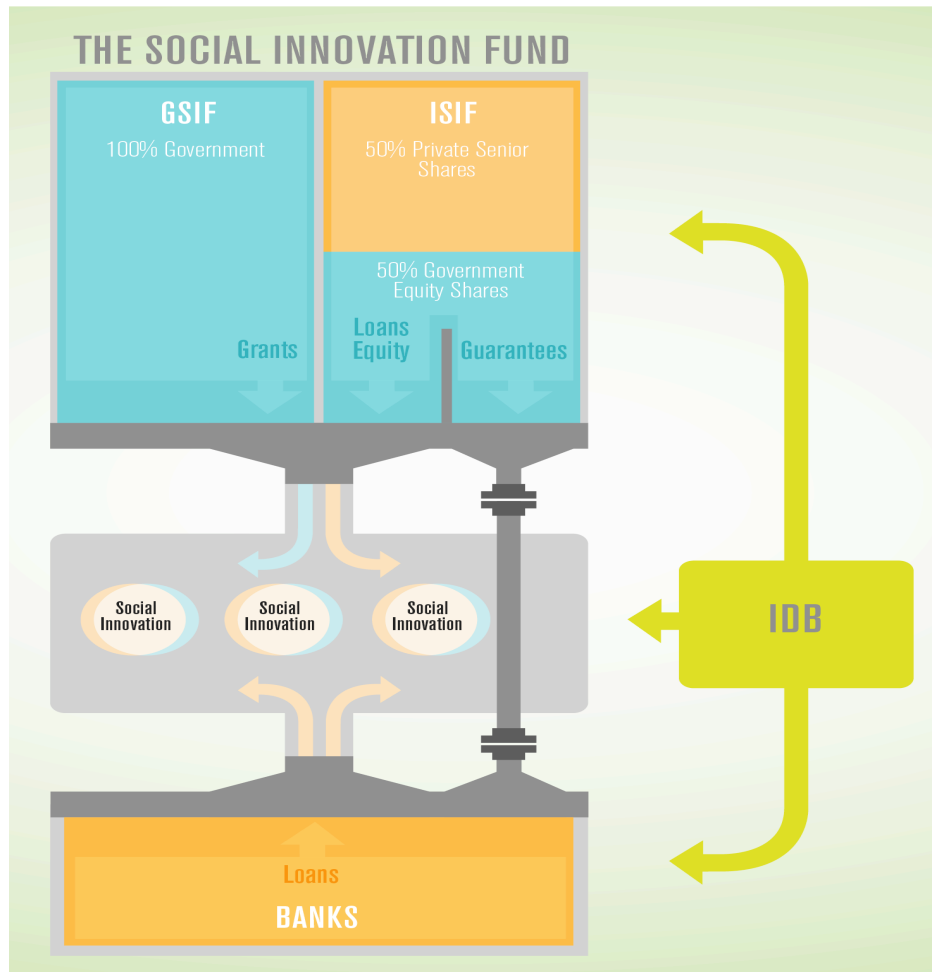
¹ For more information see IDB (2012).

Given the complexity of social problems, these interdisciplinary relationships and approaches are essential to designing different types of innovation. In addition, they provide insights into the groups' idiosyncrasies, risk aversion, financial flows, economic and human capital, and social networks. Ultimately, this mechanism facilitates legitimate social policy design, as it makes the beneficiaries active participants in the innovation process.

The Principles and Structure of the Social Innovation Fund

The **Social Innovation Fund** (SIF) would provide a private-public partnership structure created by governments with funding and support from the IDB. The SIF will aim at maximizing taxpayer money to achieve the largest social impact by mobilizing additional resources from the private sector. The SIF might adopt different legal structures depending on the jurisdiction, but it should host at least two distinct independent investment vehicles: a nonreimbursable grants vehicle fully funded with government funds (the “**Grant Social Innovation Fund**” or “**GSIF**”), and a reimbursable capital vehicle, funded with at least 50 percent government funds, which are to be leveraged to a maximum ratio of 1:1 with additional private sector funds (the “**Investment Social Innovation Fund**” or “**ISIF**”).

The basic principle of the SIF is to maximize the available resources to bring innovative solutions to the lives of the poor. For example, assuming a total allocation of public financial resources to the fund of \$100mm, the SIF would allocate \$50mm to the GSIF as grant money, and the remaining \$50mm would be allocated to the ISIF as an equity investment. The ISIF would in turn raise an additional \$50mm stake among private investors in the form of subordinated debt or long-term senior debt depending on market appetite, but in all cases, senior to the government's equity share to optimize the funds overall cost of capital. Each subfund shall maintain an independent budget.



Grant Social Innovation Fund (GSIF)

The purpose of the GSIF is to bring to life innovations that address the needs of the poor. The GSIF will provide incentives (grants, technical cooperation, and other nonreimbursable services) to firms, entrepreneurs, and universities, to motivate and generate innovations that address pressing social issues. The fund can contemplate its budget items as they relate to the development of accelerators, networking events, and research that will improve the innovation climate of those actors. The GSIF would also be in charge of launching and managing the online public consultation process of the problem and solution contest (see more below). In summary, the GSIF will finance the activities that traditionally have been financed by the CTI innovation programs,² and will use the same criteria in terms of project selection, level and type of support, lessons learned, and best practices.

² For more information, visit: <http://www.iadb.org/en/topics/competitiveness-technology-and-innovation/competitiveness-technology-and-innovation,1366.html>.

Investment Social Innovation Fund

The ISIF's purpose is to finance the scaling-up of social innovations through private sector participation. The Fund shall maintain a more commercial approach as it aims to attain financial independence by the means of the returns of its investments, loans and guarantees. The ISIF will aim to construct an investment portfolio that yields enough resources to pay the managing fees of the IFM (market practice is about 2 percent of the outstanding portfolio), and to remunerate private investors with the agreed expected return in accordance to their seniority position in the fund.

Private financiers could be both local and international. They can include philanthropies, foundations, pension funds, high net worth individuals, impact investors, banks, and other private sector actors, interested not only in the financial return of the fund, but the potentially high social returns. Ideally, the private financiers would have a social profile themselves (i.e., impact investors, socially responsible investors, foundations, etc.). This would allow for a more aligned vision with the social objectives that the SIF is aiming to achieve, and also potentially lower the financial return expectations on their participation in the ISIF, so that the ISIF's all-in cost of capital could be lowered and thus the financing costs for the social innovation projects as well. The IDB would support the government to raise additional funding for the ISIF.

As opposed to traditional equity investors, the governments' expected return on its \$50mm stake in the ISIF would be zero. It would only aim at capital preservation, that is, at the end of the life of the fund the \$50mm should have been preserved to allow for potential reinvestments or expansion of the ISIF's life or mandate.

The prudent leverage ratio of 1:1 with zero percent yield expectation on the equity tranche drives two important consequences:

1. **Risk mitigation for private investors:** 50 percent of the investments (both equity capital and loans) in social innovations will have to fail and not be repaid before private investors are faced with losses.
2. **Soft financing for social innovation:** If 50 percent of the SIF's capital expects no return, the financing cost for the investees and borrowers of the ISIF's funding are halved while ISIF's private investors still receive an adequate return. For example, if investors in the fund expect to receive 10 percent return for their 50 percent stake in the ISIF, the resulting blended cost of capital for the ISIF is 5 percent and therefore, it could make investments in social innovation at half the real market cost.

The ISIF shall offer a blended mix of products, depending on the complexity of the innovation, stage in the life cycle, the maturity of the executing company, or potential co-financiers. The

decision about which financial product best applies to concrete projects shall be made by the IFM.

1. **Equity investments.** Provided to the youngest start-ups in need of a fresh capital inflow to make initial investments in R&D and production capital. The ISIF shall be looking at exit strategies within a 5 to 10 year horizon aiming at price-to-book ratios of 1.5x. Given the higher risk profile and less liquidity of equity products, the ISIF's equity portfolio shall not exceed 50 percent of the total portfolio.
2. **Long term below market rate loans.** Provided to more mature companies with sufficient leverage capacity looking for long term, low-cost funding.
3. **Guarantees.** Provided to cover social innovation projects' credit risk in loans delivered by local banks. The level of risk coverage provided by the guarantees can range significantly, depending on the credit profile of the underlying project. Banks in return would be expected to provide long term funding to the underlying projects, at the rates that they would lend to the government (as this would be the actual risk they would be facing), instead of the higher rates at which they would lend to the projects given their arguably higher credit risk. The government could launch a partnership agreement with several local banks to encourage them to lend to the social innovations at the project level. The private sector window of the IDB could directly lend to the local banks to provide them with the long-term liquidity needed to later on-lend on a long-term basis to social projects. Additionally, those projects executed by mature companies could also receive direct funding from the IDB's private sector window, which lends directly to corporates with no sovereign guarantee.

The SIF's Governance Bodies

The SIF shall have two decision and management bodies: the Independent Interdisciplinary Selection Committee (IISC) and the Independent Fund Manager (IFM).

Independent Interdisciplinary Selection Committee (IISC)

1. Determine which ideas have the potential to be scaled and implemented.
2. Select the business plans and companies that could execute the selected, scalable ideas.
3. Monitor the financial and social performance of the SIF and provide guidance to the IFM.

The IISC would come together every time the problems and solutions contests are launched. It shall also hold a quarterly meeting to review the portfolio of companies and provide strategic advice to the IFM. The IISC committee should be comprised of five experts from: (i) the social sector, related to the nature of the social issues being treated (i.e., health, education, public safety, etc.) to ensure that the suggested solutions actually address the social challenges engrained in the problem; (ii) the government, to ensure that the suggested solutions are aligned

with government priorities in that particular sector; (iii) private sector companies operating in that particular industry, to provide a realistic angle about the challenges that a private company could face when implementing such a solution and what could realistically be done about it; (iv) the venture capital industry, to provide inputs on lessons learned from the start-up world and identify which ideas have the ingredients that could make them successful innovations; and (v) the banking industry, to provide insights into which ideas could be interesting targets to receive bank financing after surviving their early stage.

Independent Fund Manager (IFM)

The IFM would be selected by the IISC through a public bidding process. The IFM would report directly to the IISC. Once the ideas and their executors are selected by the IISC, the IFM would manage the investments on behalf of the ISIF. The role of the IFM would be that of a venture capitalist, responsible for not only structuring the terms and conditions of the most appropriate financing instrument, but additionally accompanying the investments and projects through their growth cycle by providing guidelines and expertise.

Recent research shows that an investment manager’s expertise and advice is crucial to the success of innovative projects, especially those in their early life stage, in the context of impact investments.³ Therefore, the IFM shall demonstrate a proven track record as investment manager both in private equity and fixed income, in the context of investments in innovative companies, both locally and internationally. The IFM would be in charge of the following duties and responsibilities:

1. Determine the adequate financial product (i.e., equity or loan) to support the innovation, depending on the life cycle of the innovation, the nature of the problem to be solved, the type of beneficiaries and the type of provider bringing the solution to scale.
2. Negotiate the terms of the contracts and financing to be provided to each executing company (tenor, covenants, interest rate, etc.).
3. Accompany the investments through their different stages of growth by providing expertise, including the negotiation of additional financing with other co-investors and exit strategies by selling the companies once they have achieved financial maturity.
4. Gathering reporting data on both financial and social performance to be reported to the SIF.

The Four Phases of the Social Innovation Process

The realm of social problems that could be tackled and approached through innovation is vast. The prioritization by governments of topics such as child malnutrition, improving school

³ See Keystone Accountability “What Investees Think.” Available at <http://www.keystoneaccountability.org/node/516>.

education, infant mortality and others is driven by the government's social agenda. Once a topic has been identified we can spark the social innovation process, which includes the following four phases.

1. Identifying the challenges

The creation of high-impact social innovation starts with the identification of the problem, which can only be successfully achieved by involving the beneficiary groups and citizens. The beneficiaries are the only people truly suited to identify their problems. This does not mean that it is enough to ask them directly about their challenges and concerns. In some cases a direct approach might work, but in other cases identifying solutions might require careful analysis in order to support them to reveal their preferences.

Role of the SIF

The SIF, through the GSIF, would finance and support the launch of a problem contest on the priority topics identified by the government. The contest would capture the opinions and preferences of the final beneficiaries about their most relevant issues that need to be addressed. The problem contest would be public and transparent, and should promote the interaction among the beneficiaries, academics, government and private sector.

2. Identifying the solution

The problems identified demand solutions that specifically address their challenges. This phase entails the identification of innovative solutions through web-based contests open to firms, entrepreneurs, and universities, among others. Innovative solutions are those that create value and address problems in a new and creative way. These solutions usually involve technology development and entail inherent risks and uncertainties.

At this point we are not considering the scalability of solutions. The contest for problems and solutions is a mechanism to foster and generate new ideas. Not all ideas can be scaled, and yet, the development of ideas can generate positive externalities, critical mass, and a multitude of positive collateral effects. For this reason, the generation of potential solutions at the idea-level is a good public policy in itself, and thus worth the exercise. From the ideas that surface, some will have the potential to be scaled and become a social innovation, while others will not.

The exercise entailed in phase 2 would resemble a participatory democracy process. Beneficiaries would have the possibility to contribute their ideas to the identification of the solutions. A panel of experts (some with a technical background in the field of the solutions proposed) will select the solutions especially in terms of their degree of innovation. They should consider other elements as well, related to the potential economic and social impact of the solutions.⁴

⁴ The IDB's CTI innovation programs offer lessons learned and best practices for the selection of innovation projects and can serve as a model to inform this process.

Role of the SIF

The SIF, through the GSIF, would launch a solutions contest with a clear set of challenges that need to be addressed, as identified in phase 1. This context would be open to anybody interested in contributing with the knowledge and experience in tackling a social issue.

This solution context would concentrate on the generation of ideas, not the business plan that would drive their implementation. By not restricting the contest exclusively to bidding companies with ready-to-implement business plans, the possibility of generating a larger and richer pool of ideas is greater. The ideas process could also entail a crowdsourcing angle, such as an open public voting for citizens to rank their preferred solutions. The GSIF team would be responsible for launching the solution contest via a web portal, providing support related to managing the contests and managing web communication.

3. In search of the scalable innovation

All innovations start with an idea, but not all ideas lead to innovation. What makes an idea become a high-impact innovation is its scalability, that is, the possibility of executing the idea in an efficient and effective way attaining the necessary economies of scale to create impact at a large scale. The more scalable an innovation is, the larger its social impact. The ideas generated by the public brainstorming triggered by the solutions contest need to go through a scalability filter that would determine whether they have the potential to be scaled.⁵

Role of the SIF

The IISC would be in charge of applying the scalability filter and selecting the private companies that have the best credentials to scale those ideas and transform them into successful innovations. The filters would be applied in a two-step process:

1. In the first selection process, the IISC would examine the pool of ideas received, to determine which of them meets the criteria for successful scalability while fully addressing the social challenges identified in phase 1. In order to do so, the IISC would apply the experience of the IISC members and lessons learned from the venture capital and private equity industry to determine which ingredients or common denominators lead to a scalable and successful business model.
2. Once the solutions with potential to be scaled have been identified, the SIF would launch a public bidding for companies to submit business plans to implement the social innovation. The business plans could be submitted by already established companies that would nest the project in-house, and also by social entrepreneurs that would develop a

⁵ The Stanford Social Innovation Review for instance, has identified at least five key necessary ingredients: mission fit, understanding the problem to solve, structures that mitigate risks, adding value beyond dollars and measuring financial and social returns. http://www.ssireview.org/blog/entry/building_venture_capital_from_within

startup company devoted to address the identified social challenge. The IISC would then select the business plans that best address the implementation process. In this case, the selection criteria would focus on the experience and credentials of the managers, suggested improvements to the implementation process, realistic financial projections, partnerships, networks, among others.

4. Scaling the social innovation

To successfully scale a social innovation, two main ingredients are required:

1. **Incentives.** For entrepreneurs, incentives include salaries to cover living expenses, support through incubators and networks, financing for intellectual property rights (IPR) expenses, registration, patents, labs tests, coaching, high-level scientific assistance, support to preparation of business plans, among others.
2. **Patient capital.** Patient capital investors are willing to invest in a project with no expectation of turning a quick profit. By supporting the project with capital inflows in its early life stage, they forgo an immediate return in exchange of larger returns in the long term, blended with social returns.

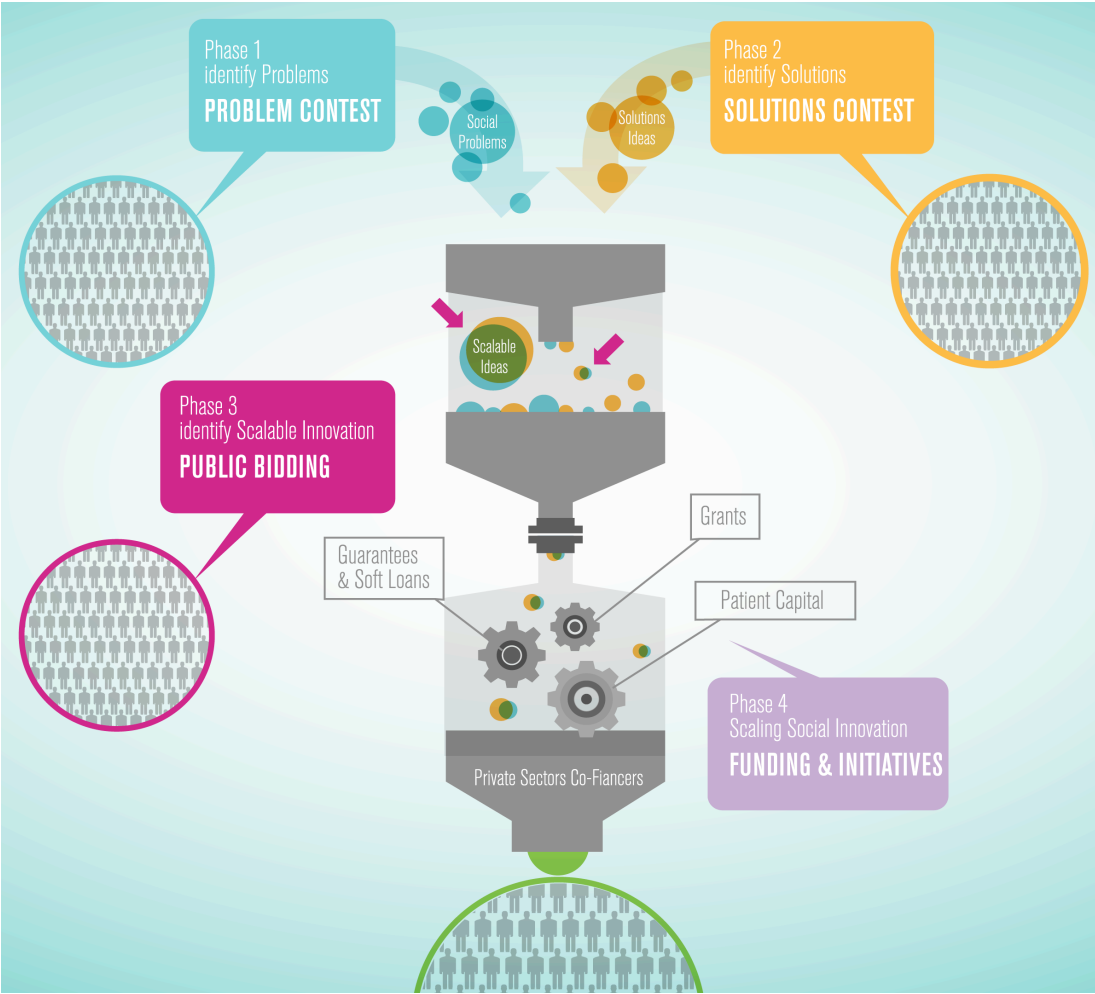
Role of the SIF

The SIF would provide the two ingredients necessary to scale innovations: the GSIF would provide the incentives, while the ISIF would provide the patient capital. The IFM would be in charge of structuring and negotiating the adequate long-term financial instruments. Depending on the characteristics of the executing company or project, the IFM will assess which instrument is most appropriate, including a blend of the two. The IFM will also work with the project managers to structure the conditions of the investment. This process will include working on the financial projections of the project to assess at which point in time dividend payments, equity exits, or in the case of loans, coupon or notional repayments would be most appropriate. Financial costs will also be a part of the negotiation. The IFM shall assess the risk entailed in the projects and seek a remuneration that reflects that risk, while allowing both the social innovation project and the ISIF itself to meet their respective return targets.

In addition to the long-term and patient ISIF capital support, the SIF could also use resources of the GSIF to help the selected projects raise additional funds through other channels. For instance, crowdfunding models such as Kickstarter, CIA start-up funding, sports team betting models, and others. These alternative fundraising models would help better connect philanthropic desires with socially minded goals.

Finally, the government through the SIF could create partnership agreements with local banks to finance the underlying projects directly. Local banks would provide long term loans to the SIF's

projects while benefiting from full or partial guarantees from the ISIF. The guarantees would allow local banks to lend at a reduced cost given that the ISIF would be taking on the banks' risk (the risk of the ISIF not honoring the guarantee if the project defaults). The IDB would lend long term resources to the local banks so that they could match assets and liabilities when lending long term to the social innovation projects.



What Makes the SIF Different from other Innovation Funds?

Three characteristics differentiate the SIF:

1. The engagement between citizens, government and private sector players by the means of crowdsourcing ideas to identify the real social problems and solutions. This is a way of ensuring social impact. The money goes to those projects that have been identified by the real beneficiaries as relevant to their situation and needs.

2. The private public partnership. The SIF brings together in a symbiotic manner two sides of the equation that complement each other, but which do not always coincide. On one side governments already spend large amounts of money in innovation, without necessarily leveraging their resources. On the other side, private sector investors often lack the patient capital or the grant resources that could help them scale up its impact. By combining both pieces together, the potential impact achieved could be much greater.
3. The SIF also opens the door to leveraging external resources by financing directly the underlying projects by the means of partnerships with local banks covered by guarantees provided by the SIF.

Table 1. Defining the Role of the Public and Private Sector

Phase	Private sector	Public sector (government)	Beneficiary citizens
1. Identifying the problem		Design and implement instruments to discover the preferences and needs of the beneficiaries (problem contest)	Reveal their preferences
2. Identifying the solution	Propose solutions	Launch solution contest	Participate in the identification of the solution
3. Identifying the scalable idea	Design innovations that provide solutions to the problems identified and prioritized	Finance solutions/innovations	
4. Scaling the social innovation	Execute business plans to implement the solution Private investors and banks finance executing companies to implement solutions	Provision of incentives and patient capital to executing companies Provision of guarantees and first loss cushions to private investors	

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