

Economic Theories of the Social Sector: From Nonprofits to Social Enterprise

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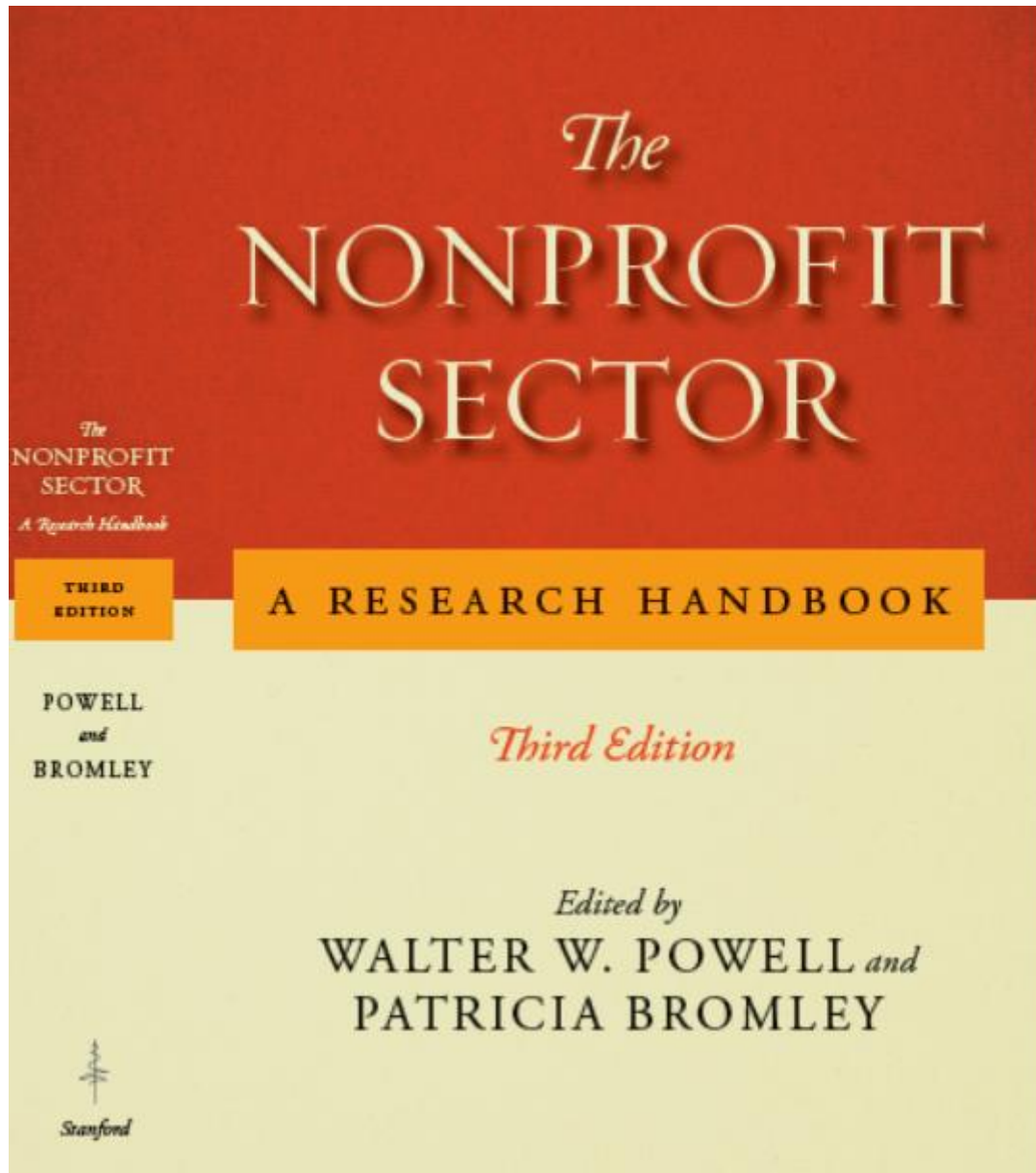
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Introduction

The Original Dilemma of Economists? The Two Adam Smiths

- ▶ “It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages.” *The Wealth of Nations*, 1776
- ▶ “How selfish soever man may be supposed, there are evidently some principles in his nature, which interest him in the fortunes of others, and render their happiness necessary to him, though he derives nothing from it, except the pleasure of seeing it. Of this kind is pity or compassion, the emotion we feel for the misery of others, when we either see it, or are made to conceive it in a very lively manner.” *The Theory of Moral Sentiments*, 1759

- ▶ Economists have adopted a simplifying strategy that goes back at least to John Stuart Mill (1867)"[Political economy] does not treat of the whole of man's nature . . . it is concerned with him solely as a being who desires to possess wealth, . . . it predicts only such . . . phenomena . . . as take place in consequence of the pursuit of wealth. It makes entire abstraction of every other human passion or motive."
- ▶ This strategy involves three **separation** assumptions
 - ▶ Separation between markets and the government (aggregate level)
 - ▶ Separation between preferences and organizational form/performance (organization level)
 - ▶ Separation between intrinsic and extrinsic motivation (individual-level)

Separation between markets and the government

- ▶ Markets are the most efficient way of producing private goods but not for public goods (or mitigating public bads) where appropriate tax/subsidy or direct provision by the government is warranted
- ▶ Also, tax and redistribution to tackle inequality & poverty
- ▶ First and second welfare theorems: separation between efficiency role of markets, and distributional concerns

Separation between preferences and organizational form

- ▶ Firms maximize profits independent of the preferences of the people involved or competitive markets will push them out
- ▶ Individuals maximize utility as investors, consumers or workers to decide how much to sell, buy, where to work, invest etc
- ▶ Production efficiency and preferences are separable
- ▶ Business is business, and that does not mix with pleasure or ideals
- ▶ No impact of preferences on the organization of production: purely driven by technology, resources and forces of competition
- ▶ Assumes there is a government sector and/or a charity sector that takes care of everything else

Separation between intrinsic and extrinsic motivation

- ▶ Individuals have preferences over various occupations, effort levels (as workers), goods and services (as consumers), investment opportunities (as investors)
- ▶ For example, a worker may have a lower cost of effort when he is working in a task he likes - intrinsic motivation
- ▶ Money (wages, prices, returns) also affects the choice of individuals to work, buy, or invest
- ▶ These can be treated separately - if someone pays you to do something you like to do anyway, then you do it even more
- ▶ More formally, intrinsic and extrinsic motivation are substitutes

Economic Theories of the Social Sector

- ▶ The substantial presence of private nonprofits in the economy provides several conceptual challenges to economists.
- ▶ It points to a grey zone in the neat black and white separation of the economy into a profit-driven private sector that produces private goods efficiently, and a public sector that corrects market failure, provides public goods etc
- ▶ If a private organization is not maximizing profits, it becomes a challenge to model its behaviour - what is it maximizing and how do we know that it is not profit-maximization by another name?
- ▶ How can an organization that does not maximize profits survive competition from for-profit organizations to the extent there are no entry barriers?

Trends within Economics

- ▶ Increasing emphasis on pro-social motivation and how it interacts with incentives and selection
- ▶ Particularly relevant in settings where
 - ▶ Outputs have significant social returns that are not largely captured in private returns, due to classical externalities or distributional concerns
 - ▶ Both outputs and inputs are difficult to measure that prevent a fully efficient solution due to agency problems.
 - ▶ Agents have some pro-social motivation - moving beyond the narrow view of economic agents as homo economicus, who are solely driven by private returns, such as, money and leisure and allow for a richer set of motivations (Benabou and Tirole, 2006; Bowles, 1998, 2016; Akerlof and Kranton, 2000, 2005, 2010; Besley and Ghatak, 2005, 2017).
- ▶ Outside of economics, exploring the implications of pro-social motivation would need scant justification, but strong tradition of putting self-interest at the core of economic models

Social Enterprise

- ▶ There has been a large literature on the economics of nonprofits since the early 1970s (e.g., Hansmann, 1987) that provide a convincing explanation of why the organizational form of nonprofits may be a constrained efficient solution to some underlying contracting problems
- ▶ However, it does not provide an obvious framework to explain the rise of more hybrid forms of organizations in the social sector, often called social enterprise, which cannot be fitted into the simple partition of the economy into for-profits, nonprofits and government organizations.
- ▶ These are more flexible forms of organizations and combine features of both nonprofits and for-profits.

A Conceptual Framework

- ▶ We start with the cost-quality trade-off as a canonical model of contract failure that lies behind existing theories of nonprofits
- ▶ Discuss the rise of social enterprise and provide some examples of these “dual-mission” organizations
- ▶ Provide a theoretical framework where managers with pro-social motivation can overcome the rigid mission problem of both for-profits (objective is to maximize profits) and nonprofits (do not maximize profits)

Cost-quality trade-off

- ▶ Suppose the quality of a service can be high or low, namely, $q = q_h$ or $q = q_l$ but it is not directly measurable or observable to the consumer.
- ▶ To produce higher quality, costs are higher to the firm
- ▶ Suppose the costs of producing high and low quality are c_h and c_l respectively, with $c_h > c_l$.
- ▶ As quality cannot be directly observed or measured, only a single price can be charged for this service, which is denoted by p .

Cost-quality trade-off

- ▶ If this is a for-profit firm, then choosing low quality would yield a profit of $p - c_l$ (which we denote by π) which is higher than the profit if high quality is chosen instead, namely, $p - c_h$ (which we set to 0 for simplicity).
- ▶ If this is a non-profit firm, then the manager or owner does not directly benefit from the cost-savings that arise from lower quality and will therefore have no incentive not to provide higher quality.
- ▶ This is a very simple illustration of a cost-quality trade-off, which is an example of contract failure.

Mission Integrity Problem

- ▶ Besley-Ghatak (2017) propose the mission integrity problem as a generalization of the multi-tasking problem that is behind the cost-quality trade-off
- ▶ Suppose it is possible to verify the action of the manager, namely whether the pro-social or the commercial action was undertaken.
- ▶ The problem is, suppose now there are two types of situations that can arise.
 - ▶ Sometimes social considerations indeed outweigh the financial consideration and so taking the pro-social action is the right thing to do.
 - ▶ However, in other situations, financial considerations may outweigh social considerations and there, the commercial action is the appropriate one.

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Mission Integrity Problem

- ▶ The issue is, only the manager gets to observe the true situation and so by observing his or her actions we cannot figure out whether the right thing is being done.
- ▶ One example of an institution that is designed to protect mission integrity with a rigid mission is a nonprofit firm - but then cannot take commercial action when that is more desirable
- ▶ Similarly, for-profit firms maximize financial objectives & so do not take pro-social action when that is desirable
- ▶ If social enterprises are able to recruit socially motivated managers they can overcome these problems - right action in the right state
- ▶ Ironically, the non-profit clause is essential only if we assume self-interested agents - not with pro-social agents

Concluding remarks

- ▶ Key insight - selection of agents has a direct bearing on organizational form (for/non-profit or social enterprise) and vice versa
- ▶ Several important potential areas of research in this emerging literature that lies in the overlap of public economics and economics of organizations
- ▶ Of particular interest in the financing of these organizations - for example, an additional advantage of social enterprises over nonprofits is that the former can raise equity but the latter is restricted to debt.
- ▶ More generally, there appear to be several fascinating areas of future research relating to the continuum of organizations from commercial for-profits to social enterprises of various kinds to non-profits
 - ▶ The problem of mission drift and mission creep
 - ▶ Government regulatory policy regarding these organizations.