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WALTER W. POWELL *is Jacks Family Professor of Education, and Professor of Sociology, Organizational Behavior, Management Science and Engineering, and Communication, and co-director of the Center on Philanthropy and Civil Society at Stanford University.*

PATRICIA BROMLEY *is Assistant Professor of Education and, by courtesy, Sociology at Stanford University, and co-author of* Hyper-Organization: Global Organizational Expansion, *with John W. Meyer.*

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The NONPROFIT SECTOR

A Research Handbook

THIRD EDITION

POWELL *and* BROMLEY

Stanford

The NONPROFIT SECTOR

A RESEARCH HANDBOOK

Third Edition

Edited by

WALTER W. POWELL *and* PATRICIA BROMLEY

The Nonprofit Sector

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13 ECONOMIC THEORIES OF THE SOCIAL SECTOR

From Nonprofits to Social Enterprise

Maitreesh Ghatak*

ACCORDING TO THE U.S. BUREAU OF LABOR STATISTICS, in 2016, employment in nonprofit organizations represented 10.2 percent of total U.S. private sector employment.[1] Internationally, nongovernmental organizations (NGOs), a subset of organizations in the nonprofit sector that engage specifically in international development, have been supplementing and sometimes replacing government agencies in the provision of relief and welfare, social services, and various projects in developing countries. The number of international NGOs rose from less than two hundred in 1909 to nearly one thousand in 1956 to more than twenty thousand in 2005 (Werker and Ahmed 2008).

This substantial presence of nonprofits in the economy presents several conceptual challenges to economists. First, if a private organization does not seek to maximize profits, modeling its behavior becomes a challenge. After all, financial incentives are an important engine of economic activity in a market economy. If the objective of a nonprofit is not profit, then what exactly is it, and how do we know that this supposed objective is not profit maximization by another name? If the objective is some form of social welfare, how can we be sure that the rational, utility-maximizing agent of economics textbooks (often referred to as *homo economicus*) will in fact pursue it? How can we be sure that such an agent will not pursue a selfish objective, such as capturing rents? How can an organization that does not maximize profits survive competition from for-profit organizations, particularly in markets where there are no entry barriers?

Second, the existence of nonprofits calls into question the neat division of economic activity into two spheres: the market sphere and the government sphere. It points to a gray zone in the black-and-white picture of the economy that divides all economic activity into (a) a profit-driven private sector that produces private goods efficiently and (b) a public

* I would like to thank Tim Besley for many helpful discussions on this topic. Indeed, the chapter draws a fair bit on our joint work. I would also like to thank Jonathan de Quidt, Patrick François, Robert Gertner, and Hannes Mueller for helpful discussions on this topic, Linchuan Xu for research assistance, and Johanna Mair, Walter W. Powell, and other participants at the Stanford Nonprofit Handbook conference for helpful feedback. The responsibility for all errors and omissions is mine.

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sector that corrects market failures, provides public goods, and carries out redistribution to serve equity objectives.

Even within the framework of mainstream economics, some scholars are questioning these traditional views related to the motivation of economic agents. They are also questioning the simplistic model that equates for-profit firms with the production of private goods and government entities with the provision of public goods.

A large body of empirical work, especially within the field of experimental economics, has increasingly called into question the view of individuals as being driven by narrow self-interest.[2] In light of this growing body of empirical evidence, recent theoretical work in economics has moved beyond stylized models of motivation based on a narrow view of *homo economicus*—an archetypal figure that cares only about money and leisure—and has embraced a wider perspective on motivation.[3] Broadly speaking, this work has focused on different approaches to prosocial motivation, such as commitment to a mission, commitment to an identity (being a "good" or "responsible" person, a good teacher or doctor or friend or parent), commitment to an "in-group" (e.g., family, community, tribe), intrinsic rewards, reputational concerns and social norms, status rewards, and pure altruism.[4]

At the same time, a large body of evidence has accumulated on varieties of government failure related to, for example, corruption, waste, absenteeism, and poor service quality. A related development involves the rising importance of private social sector organizations, including not only nonprofits but also hybrid organizational forms such as social enterprises, public–private partnerships, and contracting-out of public service provision to private providers. The rising importance of this sector highlights the limitation of equating the provision of public goods and services with provision through government agencies.[5]

A central research objective of modern microeconomic theory has been to understand how the economic institutions that underlie the "invisible hand" of the market actually work. The starting point of modern organizational theory in economics is to understand the boundaries of the firm—that is, the classic "make or buy" decision—how much to produce in-house and how much to procure from outside. The literature that has emerged has advanced our understanding of how the scope, size, and organizational form of a firm and how it manages workers or raises capital depends on the nature of the production process, various contracting frictions, transactions costs, and informational asymmetries.[6]

A large literature on the economics of nonprofits has emerged since the early 1970s (see Hansmann 1987 for a review), and this literature addresses alternative theories of nonprofits that I review in the next section. I argue that although this literature has provided a convincing explanation of why the nonprofit form may be a constrained efficient solution to certain underlying contracting problems, it does not provide a clear framework to explain the rise of hybrid organizational forms—social enterprises, in particular—that flexibly combine features of both nonprofit and for-profit organizations. Next, I discuss the rise of social enterprises and provide some examples. After that, I discuss a new agency problem that I call the "mission-integrity problem." This concept is an extension of the multitasking problem that has been a primary focus of the literature on nonprofits, and it has the potential to provide a theoretical framework to explain nonprofits, for-profit firms, and social enterprises. A key part of my analysis focuses on the interaction between the selection of prosocial individuals in the social sector and the mission-integrity problem.

In the next section, I discuss the self-selection of motivated managers into social enterprises. Finally, I offer some concluding observations on the emerging research agenda in the economic theory of social sector organizations.

Existing Theories of Nonprofits

Many of the leading theories of nonprofits can be traced to the core insight of the multitasking literature (Holmström and Milgrom 1991) in contract theory. The term *multitasking* refers to a situation where a job involves multiple tasks and the performances of each task are not all equally measurable. In such situations, providing incentives has to strike a balance across these different dimensions. For example, if the manager of an organization is entrusted with both cutting costs and maintaining quality, which is not easily monitorable, then providing sharp financial incentives to the manager will not be optimal as that may lead to excessive cost cutting at the expense of quality. The general lesson from this literature is that if an organization has multiple outputs and its nonpecuniary outputs are difficult to measure, then a muting of financial incentives may be necessary. Moreover, if the social outputs of an organization are of great value to its owner or principal or stakeholders, then they may opt for the nonprofit form to decrease managers' incentive to pursue financial profits by sacrificing social objectives.

The existing literature on nonprofits, building on the work of Henry B. Hansmann (1980) and Burton A. Weisbrod (1988), with more recent contributions by Edward Glaeser and Andrei Shleifer (2001), identifies the nonprofit sector as a residual sector that arises to overcome market and government failure in the provision of some goods and services. According to this work, a nondistribution constraint (NDC) serves as a mechanism to overcome certain contractual problems, which Hansmann calls *contract failure*. The NDC (Hansmann 1980) used by nonprofits stipulates that nonprofits can earn revenues or generate a financial surplus, so long as they are retained for future spending, distributed to beneficiaries in some form, or given to employees who lack control rights.

This literature shows that an NDC may be a constrained optimal choice in the presence of agency problems. Motivating an agent on a contractible task (effort in increasing output or reducing costs) may produce undesirable outcomes because it leads to neglect of a noncontractible task (effort in improving quality). Given this cost-quality trade-off, for-profit entities will tend to lower costs at the expense of product or service quality, whereas nonprofits have little incentive to compromise quality in that way (see Glaeser and Shleifer 2001). This logic reflects the core insight of the multitasking model (Holmström and Milgrom 1991), since an NDC is a form of "flat" incentive. The choice of organizational form thus depends on how much the principal of an organization values quality (or any other nonpecuniary aspects of production) as opposed to profits. Here I provide a simple illustration of the logic of this theory.

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, a firm must incur higher costs. In particular, suppose the costs of producing a service of 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. In a for-profit firm, choosing low quality would yield a profit of $p - c_l$ (denoted by π), which

is higher than the profit yielded by choosing high quality, namely, $p - c_h$ (which we set to 0 for simplicity). In a nonprofit organization, the manager or owner does not directly benefit from the cost savings that arise from the low-quality choice and will therefore have no incentive not to provide higher quality.

This is a simple illustration of a cost-quality trade-off, which is an example of contract failure. A more general version of this trade-off occurs when a firm chooses an action that can be of two types, a prosocial one and a commercial one. The former type has a potential social benefit but is also costly, while the latter type has no social benefit but is low in cost. A nonprofit organization has no financial incentive to take a commercial action, while a for-profit firm has no incentive to take a social action.

A clarifying remark about using simple models like the one just presented to illustrate different economic theories may be helpful. A simple model is meant to focus attention on one particular force (e.g., the cost-quality trade-off) whose variation will determine whether a specific organizational form will emerge. However, several other variables are being held constant (the ceteris paribus assumption). For example, a simple theory of the nonprofit form may posit that this form is merely a means to attract a motivated workforce that will work at lower wages (e.g., Preston 1989; Weisbrod 1988) or a means to get tax benefits. Alternatively, where a cost-quality trade-off exists, something other than a pure nonprofit or a pure for-profit firm may emerge. For example, a profit-sharing partnership may be optimal when it is hard to assess service quality (see Levin and Tadelis 2005), and such partnerships are common in professional service industries—such as law, accounting, medicine, investment banking, architecture, advertising, and consulting—but not elsewhere. In other words, a cost-quality trade-off is neither necessary nor sufficient for the emergence of nonprofits. Unlike a general theory, a simple model indicates a likely association or a central tendency but allows for a range of possibilities that may deviate from that tendency and yet be consistent with it.

A variant of this argument suggests that charities should take a nonprofit form in order to assure donors that their money will indeed reach beneficiaries and not be pocketed by the managers of a donee organization. Contract failure arises in situations where the quality of a good or a service cannot be ascertained before (or sometimes even after) its consumption—a situation that leaves considerable scope for opportunism. Common examples of this situation include plumbing, car repair, health care, education, and child or elder care. An NDC is said to protect against opportunism; managers have a reduced incentive to compromise quality since they cannot pocket financial profits directly.[7]

It is not clear that having an NDC will eliminate opportunistic behavior. The fact that profits cannot be directly distributed does constrain the way that surplus can be extracted from a nonprofit, but salaries and perks provide a mechanism through which nonprofit managers can extract surplus. Indeed, the starting point of the work of Glaeser and Shleifer (2001) is that nonprofit managers extract surplus in an indirect and possibly inefficient way: for every dollar they extract in the form of perks or benefits, they receive only a fraction of that value, and this effect mutes their incentive to compromise quality. After all, direct cash is preferable to perquisites in the form of goods and services. The same effect reduces their incentive to maximize revenues. The literature correctly notes the downside of nonprofits that is implied by this logic: if nonprofit managers have little incentive to

pursue profits at the expense of noncontractible quality, they also have little incentive to cut costs in socially productive ways. In this respect, for-profit firms are preferable.[8]

Barring a few exceptions, the economics literature on nonprofits has placed little focus on the motivation of those who manage or work in those organizations (Handy 1995; Preston 1989; and Weisbrod 1988 are exceptions). It is often remarked that these individuals systematically differ from the rest of the population in terms of their prosocial motivation.[9] A key factor in the effectiveness of nonprofits may well be their ability to attract employees who are committed to a cause, as noted by Anne E. Preston (1989), Weisbrod (1988), and Timothy Besley and Maitreesh Ghatak (2005). This factor may in turn influence the choice of organizational form in the provision of experience and credence goods. The two-way interaction between employee selection and incentives has received little attention and will be a major focus of the next section of this chapter.

Emergence of Social Enterprise

Because of the rise of social enterprises in the last few decades, the classification of all organizations as discrete nonprofit, for-profit, or government entities is no longer possible. This development points to a basic limitation of the contract failure literature, which assumes that the choice of organizational form is between for-profit and nonprofit entities only. Social enterprises belong to a set of organizations that are neither traditional profit-maximizing firms, nonprofit organizations, nor publicly owned and controlled government agencies. These hybrid forms of organization are often referred to as *social enterprises* even though, as Roger L. Martin and Sally Osberg (2007) acknowledge, many other types of firms operate under that banner.[10]

The defining goal of a social enterprise is to balance making profits with pursuing a social mission (Katz and Page 2010). As J. Gregory Dees (1998) puts it, social enterprises combine "the passion of a social mission with an image of business-like discipline, innovation, and determination commonly associated with, for instance, the high-tech pioneers of Silicon Valley" (1). They aim to bring entrepreneurial approaches to social problems, thereby providing an alternative to the perceived rigidity and inefficiency of existing institutions in the government and philanthropic sectors.

In the economics literature, *mission* is not a widely used term, and instead individuals or organizations are said to pursue *objectives*, which can be financial (e.g., profit maximization) or social (e.g., a cleaner environment). In the management literature, *mission* involves an overall vision, while *objectives* refers to specific and concrete goals that are part of a broader strategy to achieve the mission. I will stick to the terminology of *mission*, but given that my framework here is somewhat abstract, I could substitute the term *objectives* or *goals*.

I should also clarify that many organizations—including for-profit firms—have multiple objectives, including social and commercial ones. What matters is which objectives have priority. We can think of for-profit firms as operating under strict market discipline, which requires them to prioritize profit maximization while respecting a minimum threshold for meeting certain social objectives (e.g., environmental standards). Likewise, we can view nonprofits as working to maximize a social objective, subject to a break-even constraint and an NDC. In contrast, social enterprises have a flexible approach: in some

circumstances they maximize a social objective, subject to a break-even constraint; in other circumstances they maximize a financial objective, subject to the constraint that their actions do not fall short of a minimum threshold for meeting their social objective.

Indeed, in the management literature, social enterprises are viewed as aiming to balance making profits with advancing a social mission (see Katz and Page 2010) and as avoiding the rigidity of either a nonprofit or a for-profit form. They are viewed as pursuing profit and social good in tandem, in part by making considered choices to pursue one over the other at any given time (Reiser 2010). The underlying premise is that there is a trade-off between these objectives and that both nonprofit and for-profit entities face constraints that make resolving this trade-off difficult. Because nonprofits cannot distribute profits, the nonprofit form is not an option for entrepreneurs who intend to blend equity finance with the pursuit of social goals. Managers of a for-profit firm, meanwhile, have a legal obligation to maximize profits for the firm's owners. Also, market forces push them to give priority to profit maximization over social objectives; otherwise, they risk losing both market share and investor confidence.[11]

Like most nonprofits, social enterprises are allowed to earn revenue, but unlike nonprofits, they face no equivalent of an NDC that restricts the distribution of residual earnings—no constraint, that is, other than the requirement that its activities align with its social mission. However, as Dees (1998) points out, "For social entrepreneurs, the social mission is explicit and central. This obviously affects how social entrepreneurs perceive and assess opportunities. Mission-related impact becomes the central criterion, not wealth creation" (2).

The role of social enterprises in the economy has attracted increasing attention in recent years, partly in response to the growing number of real-world examples of social enterprises in both the developed and developing worlds (see Porter and Kramer 2011). The management literature presents many interesting case studies. For example, LendStreet Financial helps reduce indebtedness among low-income people by delivering financial literacy programs and providing incentives that encourage responsible repayment (see Lee and Battilana 2013). Prior to delivering these services to a new client, LendStreet purchases the client's debt from one or more institutional investors. When clients increase their rate of repayment, LendStreet earns revenue that enables it to sustain its operations.

Consider the following examples:

In Africa, where children frequently die of diarrhea from bad sanitation, Dignified Mobile Toilets (DMT), founded by Isaac Durojaiye (who died in 2012), runs a franchise system for public toilets. He supplies mobile toilets to slum areas, where previously unemployed young people operate the toilets and charge a small fee for their use. These operators keep 60 percent of the income and pass the rest to DMT which uses the money to buy new toilets.

Nic Frances runs a group that aims to cut carbon emissions in 70 percent of Australian households over ten years. His group, Easy Being Green, gives low-energy light bulbs and low-flow shower heads to households that agree to sign over the rights to the carbon-emission credits that use of the equipment will earn. The group then sells those credits to companies and used the proceeds to finance its activities. Easy Being Green now aims to expand globally.[12]

Altrushare Securities is a brokerage firm that engages in the sorts of activities that one might expect of a Wall Street outfit, such as buying and selling stock and providing research on companies. Unlike its peers, however, Altrushare is majority-owned by a pair of charities, each of which controls about one-third of the firm. "We're a for-profit institutional brokerage, and we have to compete on execution and commissions and do so with the same technology and talent you would expect from a top-tier firm," said Peter Drasher, a co-founder of Altrushare, which is based in Bridgeport, Connecticut. "What makes us different is our non-profit ownership and our mission, which is to support struggling communities with our profits."[13]

A common theme in the literature on social enterprises is the tension between their commercial and social missions. In the commercial microfinance sector, for example, the social mission of relaxing borrowing constraints on the poor comes head-to-head with profit-seeking that may occur at the expense of the poor, raising the specter of "mission drift" (see Yunus 2011). Ben and Jerry's, an ice cream brand that was established to follow strong ethical norms (e.g., using hormone-free milk sourced from local farms) while pursuing commercial ends, was sold to Unilever at the behest of shareholders, raising questions about its future as a social enterprise (see Page and Katz 2012).

The Mission-Integrity Problem

What nonprofits, social enterprises, and the kinds of hybrid organizations discussed in the previous section have in common is that they are all mission-driven organizations that operate in settings where principals or agents may have nonpecuniary motivations and where outputs cannot be measured well enough to make standard incentive contracts useful. In some cases, these outputs are purely private goods (e.g., health care with no externalities, such as cosmetic surgery, or commercial research). In other cases, the outputs also have a public-good component, either because the goods deliver positive externalities in the form of nonexcludable or nonrival benefits (e.g., environmental protection), as one sees in standard public economics, or because society cares about directly ensuring a minimum provision of certain goods (e.g., basic health care, education, helping the poor).

The dual mission framework of social enterprises raises new agency problems for mission-oriented organizations, since the objectives of profit-making and advancing social good are often at odds in the social sector (as with the cost-quality trade-off). If we know that social goals will usually override commercial goals, then a nonprofit form will work best. Similarly, if we know that commercial goals will usually override social goals, then a for-profit firm is the appropriate organizational form. But given that social enterprises claim to be flexible in balancing social and commercial objectives, they require a mechanism that can balance those objectives in a way that is consistent with a broad mission. Besley and Ghatak (2017a) call this challenge the "mission-integrity" problem. I will illustrate this problem with a simple example.

For this purpose, I will adapt the illustration provided in the preceding section. Suppose a firm chooses an action x that can be one of two types, which I denote by 0 and 1. Earlier I equated these types with providing high quality and low quality, respectively, but here I will allow for alternative interpretations. The first type of action (denoted by 0) has a potential social benefit but is also costly, while the second type of action (denoted by 1)

has no social benefit but is low in cost. The former is a prosocial action, while the latter is a commercial action.

Suppose it is possible to verify whether a manager has undertaken the prosocial action or the commercial action. Now suppose that there are two types of situations that can arise. In one, social considerations outweigh financial considerations, and so taking the prosocial action is the right thing to do. In the other, financial considerations outweigh social considerations, and so the commercial action is the appropriate one to undertake.

However, only the manager can observe the true facts of the situation, and therefore we cannot figure out whether the manager is doing the right thing merely by observing his or her actions. What matters is that the production or distribution of a good entails a potential conflict between social and commercial objectives, and yet the underlying reason for taking an action is not observable by outsiders, including the owners or principals of an enterprise.

Several applications would fit this scenario.

Think of situations in which the goal is to widen access to certain goods or services; education, health care, and legal services are important examples. The prosocial action can be interpreted as providing access to "deserving" beneficiaries on preferential terms (e.g., free treatment for the poor), while the commercial action involves offering no special access or concessions. The manager may observe an individual who is to be served (say, a patient or a student or a potential beneficiary of a targeted welfare program) and decide what action to choose.

The social objective may also be related to externalities associated with the good's production. For example, environmental externalities may arise requiring firms to balance cost efficiency against the social costs of pollution. Suppose the commercial action is to use a standard technology, while the prosocial action is to use a costlier but more environmentally sound technology. The manager's choice is to decide whether it is worth giving up profits by choosing the latter technology if the environmental benefits that are external to the firm are substantial enough.

Situations, or *states*, are denoted by σ Like actions, they are of two types, and I will denote them by 0 or 1 as well. In state $\sigma = 0$ the prosocial action $x = 0$ is the right one from the social welfare point of view, while in state $\sigma = 1$ the commercial action $x = 1$ is the right one from that point of view. How, then, do we ensure that the manager will make the right choice—the choice that is consistent with the mission of the organization? This is the mission-integrity problem.

In Table 13.1, I provide details regarding the financial and social payoffs under the four possible combinations of actions and states. In a prosocial state, taking a prosocial action leads to a social payoff of $S = \overline{S}$ and a financial payoff of $\pi = \underline{\pi}$. However, if a commercial action is taken, the social payoff is zero, while the financial payoff is $\pi = \overline{\pi}$ irrespective of the state. In a commercial state, if a prosocial action is taken, then the social payoff is $S = \underline{S}$ while the financial payoff is $\pi = \underline{\pi}$. Here, I assume that $\overline{S} > \underline{S}$ and $\overline{\pi} > \underline{\pi}$. Moreover, I assume that in the prosocial state, it is more efficient to take the prosocial action, namely, $S + \underline{\pi} > \overline{\pi}$. In contrast, in the commercial state, it is more efficient to take the commercial action, namely, $\overline{\pi} > \underline{S} + \underline{\pi}$. This poses a sharp dilemma: How do we ensure that the right action is taken in the right state?

Table 13.1 Social and financial payoffs for various states and actions

	$\sigma = 0$	$\sigma = 1$
$x = 0$	$S = \bar{S}, \pi = \underline{\pi}$	$S = \underline{S}, \pi = \underline{\pi}$
$x = 1$	$S = 0, \pi = \bar{\pi}$	$S = 0, \pi = \bar{\pi}$

One way to ensure mission integrity is to impose a rigid mission on an organization. Nonprofit organizations, for example, are designed to protect mission integrity by following a clear social mission. Many sectors of the economy—in particular, health, education, and poverty relief—rely heavily on such organizations. Here, by design, commercial considerations are set aside, and the manager is expected to choose $x = 0$ irrespective of whether $s = 0$ or 1. The downside of this arrangement is that from a social welfare point of view, there may be times when commercial considerations outweigh social considerations. In this scenario, nonprofits are inefficient.

For-profit firms also have a rigid mission—to maximize profit. External shareholders can invest in a for-profit firm knowing that it has a legal obligation to pursue that goal. In this case, any deviation from profit maximization would pose an agency problem, even though this deviation may be carried out for the most worthy of social goals (see Friedman 1970 for a statement of this position). The downside of this arrangement is that social considerations sometimes outweigh commercial considerations. In this scenario, for-profit firms generate a negative externality.

In the existing framework, which I discussed earlier, the separation of for-profit and nonprofit entities may seem like an efficient division of labor between the provision of private goods and the provision of public goods. But the rigidity that characterizes both nonprofit and for-profit entities has a downside. From a social welfare point of view, there are times when engaging in profit-oriented activities is most desirable and times when pursuing other ends is most desirable. Thus, it makes sense to seek a more nuanced way to balance those two types of activity. That is indeed one of the claimed advantages of social enterprises: they eschew the rigidity of both nonprofit and for-profit forms. The question is, how do they guarantee mission integrity? To be effective, in other words, social enterprises have to solve the problem of achieving the right trade-off between profit and purpose.

In the absence of contractual solutions, the mission-integrity problem creates a role for what Katz and Page (2010) call "mission-sympathetic parties," who are appointed to achieve an optimal trade-off between commercial and social considerations. Selection on the basis of motivation can thus become a mechanism to achieve mission integrity. When individuals care about the mission of an organization, they will care about whether the organization is indeed committed to that mission.

Besley and Ghatak (2017a) formalize this argument and show that one key mechanism through which social enterprises can achieve mission integrity while eschewing the rigid approach of nonprofit and for-profit forms is the selection of managers who are motivated by a social mission. In that case, managers can be given a financial stake in their organization, and this incentive structure will ensure that they will "do the right thing" depending on the situation—namely, maximizing profits when that is appropriate but deviating from that practice when social objectives are more important. However, external

monitoring by stakeholders offers another option to make sure that the performance of social enterprises conforms to their social objectives.

Consider all three organizational forms: for-profit, nonprofit, and social enterprise. With a for-profit firm or a social enterprise, the manager is a full residual claimant on profits, whereas the manager of a nonprofit earns only a flat wage. For-profit and nonprofit entities curb the autonomy of managers by stipulating a rigid mission. In a social enterprise, the manager has discretion over the balance between profit and purpose.

If managers are sufficiently motivated (that is, if they put sufficiently high weight on a social payoff), nonprofits and social enterprise are equivalent, as managers of this type will always put more weight on social objectives than on profits. However, for moderately motivated managers, the flexibility of social enterprises mitigates the mission-profit trade-off, and giving them discretion over action is more efficient than the rigid approach followed by either nonprofits or for-profit firms. That is because they will always choose $x = s$, *i.e.*, $x = 1$ when $s = 1$ and $x = 0$ when $s = 0$. In contrast, managers of for-profit firms will always choose $x = 1$ while managers of nonprofits will always choose $x = 0$.

However, this effect has to be balanced against the fact that if the social payoff is very valuable to a principal or owner (or if the social state is much more frequent than the commercial one), then the nonprofit form should be chosen over both for-profit and social enterprise forms. Similarly, if the commercial payoff is more valuable to a principal or owner (or if the commercial state is much more frequent than the social one), then the for-profit form is the correct option.

This framework allows us to move beyond the for-profit-versus-nonprofit trade-off, which has been a primary focus of the existing literature on social enterprises. Another interesting implication of this framework is that when owners or principals do not like a social payoff (when, for example, they put a negative weight on it because of ideological considerations), they face a problem that resembles a standard agency problem, with the social payoff functioning like a private benefit to a firm's manager. Thus, for-profit firms that prohibit taking a prosocial action will be the preferred organizational form among owners or principals who object to a social payoff. This insight is in keeping with the well-known claim by Friedman (1970) that the only social responsibility of business is to make profits.

Selection of Socially Motivated Managers

The approach taken in the previous section challenges a central tenet of standard economic design, in which the assumption of *homo economicus* restricts attention to agents with narrowly self-interested goals. The sustainability of social enterprises actually rests on the selection of agents with appropriate motivations to achieve the right trade-off between commercial and social goals. Even though, as I noted earlier, the potential role of nonprofits in attracting motivated managers is recognized (see, for example, Weisbrod 1988), the formal theoretical literature on nonprofits has not explicitly considered the role of intrinsically motivated managers, and in particular, how their presence interacts with underlying agency problems. A key insight of the Besley and Ghatak (2017a) framework is to show that once the heterogeneity of manager motivation and self-selection is taken into account, social enterprises emerge as a natural alternative that allows the social sector to go beyond the standard for-profit versus nonprofit trade-off.

This insight provides an interesting contrast with certain assumptions that prevail in the existing literature on nonprofits. In that literature, it is assumed that managers have no nonpecuniary motivation and care only about money and their disutility of effort. As a result, nonprofit status is seen as necessary to manage the cost-quality trade-off. Once we allow for managers who have nonpecuniary motivation, nonprofit status ceases to be a necessary condition for aligning commercial and social objectives. Allowing for prosocial motivation therefore opens the door for more flexible organizational forms, such as social enterprise.

However, a key question then emerges: How do social enterprises select for socially motivated managers? Motivation, like ability or conscientiousness, is not readily observable, and one must have mechanisms in place to ensure selection of the right kinds of individuals. The selection can take the form of direct screening. An empirical implication of this argument is that social enterprises will spend much more time and effort on recruiting managers who are committed to a social mission than for-profit firms do. In for-profit firms, by contrast, ability and other standard labor market characteristics will play a larger role in recruitment screening.

There is ample empirical evidence that nonprofit and public-sector organizations recruit individuals who have more "public-service motivation" (see Cassar and Meier 2018 for a recent review). There is also some evidence that social enterprises tend to hire workers who are highly motivated to achieve an organization's mission and who fit with the values espoused by the organization (Brolis 2017).

There is a more subtle conceptual issue to consider: if the motivation or commitment level of workers and managers is not observable, what mechanisms can social enterprises use to screen for the right kinds of people? Let's extend the model to allow for two types of potential managers: selfish and motivated. Selfish managers are driven only by financial goals, while motivated managers put a weight θ on the social payoff. With respect to selfish managers, achieving mission integrity requires use of a pure nonprofit form, since only that form will remove financial calculations from their decision making. (The model assumes that in this case, selfish managers do not mind choosing the right state-contingent action, since they are indifferent to the social consequences of their decisions.).

With respect to motivated managers, achieving mission integrity requires allocating a share of profits as a bonus to make sure that they do not always choose prosocial actions at the expense of pursuing an appropriate financial payoff. In particular, let w_H be the flat wage offered in a hybrid organization and λ be the share of profits offered as a bonus. For a motivated manager to choose the right course of action in both states of the world, the following two constraints must be satisfied:

$$\theta\overline{S} + w_H \geq \lambda\overline{\pi} + w_H$$
$$\lambda\overline{\pi} + w_H \geq \theta\underline{S} + w_H.$$

The first constraint indicates that in the state where the social payoff is high, the manager will take a prosocial action. The second constraint indicates that in the state where the financial payoff is high, the manager will take a commercial action. These inequalities give a range of values for λ that will achieve mission integrity:

$$\frac{\theta\overline{S}}{\overline{\pi}} \geq \lambda \geq \frac{\theta\underline{S}}{\overline{\pi}}.$$

Thus, in nonprofits the incentives are right for selfish managers, while in hybrids the incentives are right for motivated managers. Put differently, the selection of workers and managers for nonprofits and the choice of the nonprofit form are not independent, as it would appear from the existing literature, in which one strand of research (e.g., Weisbrod 1988) focuses on the selection aspect while another strand (e.g., Hansmann 1980) focuses on the role of the NDC in curbing incentives for managers to let commercial considerations override prosocial considerations. The main argument for nonprofits—namely, that it removes commercial considerations from decision making—is reinforced if there are grounds to believe that not every decision maker fully agrees with the mission of his or her organization. Likewise, if decision makers are indeed committed to the mission, then contract failure is less likely and one can consider relaxing the rigidities of the NDC (e.g., if the NDC limits an organization's ability to access capital).

However, a key question remains: How do organizations solve the selection problem? If individuals are heterogenous in terms of their commitment to the mission of an organization and if information on their commitment level is not observable, how can the organization make sure that it selects the right managers? This is the classic problem of self-selection: If the quality of an applicant is subject to private information, is it possible to design a compensation package that will select for the "right" kind of applicant?

Suppose two types of organizations are in place, a nonprofit and a hybrid, and the former offers a flat wage w_N and the latter offers both a flat wage w_H and a share of profits λ as a bonus. Is it possible to set these values in a way that satisfies the mission-integrity constraints of both organizations *and* in a way that leads selfish agents to self-select for the nonprofit and motivated agents to self-select for the hybrid organization? A distinctive aspect of the problem, as it turns out, is that meeting those conditions is not possible. In standard problems that involve asymmetric information, we typically worry about the self-selection constraint on one type of agent but not both. Yet here, we have to worry about the self-selection constraints on both types of agents. To make the nonprofit attractive to selfish agents, the flat wage has to be high, but in that case motivated agents will also be attracted to the nonprofit: they get the social payoff by choosing the prosocial action in both states of the world. To make the hybrid attractive to motivated agents, the bonus has to be set high (as high as the mission-integrity constraint will permit) to offset the lower flat wage, but in that case the hybrid becomes attractive to selfish agents as well!

Let $\hat{\pi} = q\underline{\pi} + (1-q)\overline{\pi}$ be the average profit when a commercial action is chosen in both states of the world, and $\hat{S} = q\overline{S} + (1-q)\underline{S}$ be the average social payoff when a prosocial action is chosen in both states of the world. Then the self-selection constraint for selfish agents to prefer a nonprofit is

$$w_N \geq \lambda\hat{\pi} + w_H.$$

The corresponding self-selection constraint for motivated agents to prefer a hybrid is

$$q\theta\overline{S} + (1-q)\lambda\overline{\pi} + w_H \geq \theta\hat{S} + w_N.$$

Intuitively, the flat wage differences must be such that (a) selfish agents would not want to work in a hybrid organization, and (b) motivated agents would not want to work in a nonprofit. The trouble is, there is only one instrument—the wage difference—to achieve both goals, and using that instrument turns out not to be possible.

Formally, $\lambda\hat{\pi} > q\theta\overline{S} + (1-q)\lambda\overline{\pi} - \theta\hat{S}$, as this is equivalent to $\lambda q\underline{\pi} > -(1-q)\underline{S}$, which is always true. Thus, both parts of this dual requirement—that the nonprofit wage premium $w_N - w_H$ must be greater than $\lambda\hat{\pi}$ to attract selfish agents to the nonprofit sector, and that it must be smaller than $q\theta\overline{S} + (1-q)\lambda\overline{\pi} - \theta\hat{S}$ to prevent motivated agents from joining the nonprofit sector—cannot simultaneously hold.

That means there are two possible options. First, one can set the wage in hybrid organizations so low that selfish agents will not join them, while motivated agents will opt to join nonprofits instead. Second, one can set the nonprofit wage at a level that is unattractive to motivated agents, but in that case selfish agents will be drawn to hybrid organizations. Both options have downsides; a selfish agent in a hybrid organization will pursue only financial objectives since he or she gets a share of the profits as a bonus and does not value the social objectives by the assumption of being selfish, while a motivated agent in a nonprofit will pursue only social objectives since financial incentives are absent.

Two factors suggest that the former is likely to be the preferred "second-best" option. First, there is a paucity of motivated agents relative to selfish agents in the population. Screening out selfish agents, therefore, is a much bigger concern than screening in motivated agents. Second, within the social sector, the loss from pursuing a commercial objective when a social objective should receive priority is likely to be of greater concern than the loss from pursuing a social objective when a commercial objective should receive priority.

We do not have direct evidence to support the model outlined here. However, existing work on nonprofit wage differentials suggests that it should be possible to carry out similar work with respect to social enterprises. For example, there is some evidence that at the same qualification level, nonprofit workers earn less on average than for-profit workers. However, when the labor market is tight and for-profit and nonprofit employers compete, a wage gap between the two sectors may not be observed. Recent work shows that if one controls for this demand-side factor, the relationship between that wage gap and the share of labor demanded by nonprofits is driven by "motivated types" sorting into nonprofit jobs who are willing to take a wage cut (Jones 2015). There is also evidence that those who work in the nonprofit sector believe they are underpaid but choose to continue to work in the sector for reasons that are value-based and because they find certain job characteristics appealing (Handy et al. 2007). There is also evidence that measures of prosocial motivation predict the decision to work in the nonprofit sector, and that workers in the sector accept a wage discount for that reason (Serra et al. 2011).

Concluding Remarks

An emerging research area seeks to understand the social sector from an economic point of view and to integrate the sector either into a standard economic framework that applies to for-profit firms producing private goods (e.g., economics of contracts and organizations, industrial organization, finance, labor) or into a standard framework that applies to government entities providing public goods (e.g., standard public economics).

Much of the economic reasoning that underpins the standard understanding of resource allocation in the private sector does not quite apply to the social sector. To start with, the quality of goods and services provided in the social sector—which include experience goods to credence goods—is typically non-contractible. Also, many of these

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goods and services have externalities: that is, their benefits or costs are partly external to the organization that provides them. According to Ronald Coase (1960), the inefficiencies that arise from externalities have to do with the difficulty of creating property rights. In the standard economic framework for private goods, making the decision maker in a firm the residual claimant on property rights leads to efficient outcomes. In fact, "creating property rights" and "contractibility" are very similar concepts. If output is hard to measure and/or attribute to a given agent (e.g., in the moral hazard problem that applies to teams), then how do you pay people appropriately for their marginal product? If quality is noncontractible, then how do you charge buyers a price that reflects the value that they place on it? The core issue in the kinds of problems that I have discussed—the kinds of problems that have traditionally been the focus of public economics—is noncontractibility, namely, when the output is difficult to measure and price. If noncontractibility is not the issue and output is measurable, then nonrivalry (namely, one person's consumption not reducing another person's consumption, as is the case with standard private goods like apples) simply changes the pricing formula (e.g., subscription or rental rates for cable TV) from that of standard private goods, without requiring any major change in the analytical framework. Naturally, the emerging research agenda draws on insights and tools both from the economics of contracts and organizations and from public economics.

There are several important potential areas of research in this emerging literature. Of particular interest is the financing of social enterprises. For example, one advantage of social enterprises over nonprofits is that the former can raise equity while the latter can only incur debt. More generally, there are several fascinating areas of future research related to the continuum of organizations that spans from for-profit firms to social enterprises of various kinds to nonprofits. With respect to social enterprises, topics for future research include organization design (e.g., delegation, ownership structure) and the implicit and explicit incentive mechanisms (e.g., reputation, career advancement, incentive pay) that these organizations use; quality, performance, and impact assessment of the outputs of these organizations; how these organizations interact at an industry level and how they interact with other types of organizations; and government regulatory policy regarding these organizations.

Chapter 13

1. A study of eight OECD countries from roughly a decade ago (Salamon et al. 2007) shows that nonprofit organizations contributed 8 percent to GDP on average (7.2 percent in the United States). Health, education, and social services accounted for 61 percent of the contribution of nonprofits to GDP on average in those eight countries. More recent estimates suggest that the contribution of the nonprofit sector to the GDP of the United States has declined slightly to 5.4 percent in 2015 (see McKeever 2018).

2. See Besley and Ghatak 2018 for a recent review of this literature.

3. See Akerlof and Kranton 2005, Benabou and Tirole 2006, and Besley and Ghatak 2005.

4. This work can be separated from behavioral economics, which studies departures from certain consistency axioms in a rational choice framework. One can have many objectives other than maximizing private wealth or consumption of private goods and yet be strictly rational. Even in standard public economics models, people care about public goods and services. In this literature, the premise is that there is some failure in government provision of public goods, regulations, and private voluntary actions by individuals (e.g., models of voluntary charitable contributions).

5. See Besley and Ghatak 2017b for a discussion.

6. See Gibbons and Roberts 2013.

7. More generally, reputation can be an important incentive mechanism when the quality of a good is intangible, as in the case of experience goods.

8. This is a modified version of the multitasking argument of Holmström and Milgrom 1991.

9. See Ortmann 1996 for a discussion.

10. Terms like *public benefit corporations* (Shiller 2012) or *B corporation* (Reiser 2010), *social enterprise* (Dees 1998; Bornstein 2004), *social business* (Yunus 2007), and *community interest company* (Reiser 2010) are part of an emerging lexicon, but all stand for somewhat different organizational forms.

11. See Reiser 2010 for a discussion from a law and economics perspective. The legal framework for hybrid organizations is evolving, and there are many unresolved questions. For example, as Rachel Culley and Jill R. Horwitz (2015) note, a key question focuses on how to solve legal disputes that occur when profit making and social purpose conflict.

12. See Kristof 2007.

13. See Strom 2007.

Chapter 14

1. For an insightful conceptual attempt to examine variety within country contexts, see Defourny and Nyssens 2017.

2. All interviewers participated in an on-site training week before conducting the survey and participated in biweekly coaching and reflection sessions during the interview period.

3. In Germany and Portugal, a few social enterprises have very large revenues—revenues of more than €100 million and €10 million, respectively.

4. Employment and volunteering seemed to be weakly positively and significantly correlated, suggesting that these two activities can be understood as weak complements to, rather than substitutes for, the social enterprises in our sample (Huysentruyt and Stephan, 2017).

5. Examples of nonprofit legal forms include charities, associations, federations, foundations, community interest companies, social solidarity institutes, limited liability companies with public benefit status, and private nonenterprise entities (China-specific).

6. Examples of for-profit legal forms include limited liability companies, general partnerships, limited companies with shares, partnerships organized under the civil code, and unincorporated businesses (China-specific).

7. Once it registers as a CIC, a social enterprise cannot receive donations. Another reason why social enterprises that are eligible for other for-profit forms may not adopt the CIC form is that CIC regulation imposes a cap on dividends that they can distribute.

8. Details of this analysis are shared in the cross-country report at http://www.seforis.edu.

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