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

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Economic theories of organizations that depart from the standard models of profit-maximizing firms are reviewed. This document will discuss earlier theories of nonprofit organizations that focus on contract failure and will argue that this framework that underlies those theories cannot explain hybrid organizational forms such as social enterprise. These forms aim to balance social and financial objectives in order to avoid the rigidity of both for-profit and nonprofit forms. Conditions under which a social enterprise is likely to be preferable to either a nonprofit or for-profit alternative are characterized. Additionally, this paper highlights the importance of selecting managers and workers who are motivated by the mission of an organization.

Keywords: nonprofits; social enterprise; mission-integrity; motivation

1. Introduction

The social sector (also called, among other names, the voluntary and the third sector) comprises of a whole spectrum of organizations that are not purely for-profit organizations nor directly run by the government.¹ It incorporates a range of organisation types, including nonprofit, community, civil-society, and charitable organizations. Increasingly, organisations are emerging that blend elements of such nonprofits with elements of for-profit organisations, such as social enterprises.

In most developed countries, this sector is quite large. According to the U.S. Bureau of Labour Statistics, in 2017, employment in nonprofit organizations represented 9% of the total workforce.² Certain sectors, such as healthcare, see nonprofits hold a dominant presence, with nearly 50% of all US hospitals being nonprofit hospitals (American Hospital Association Hospital Statistics, 2020). Among Northern European countries, nonprofit employment is slightly lower, with nonprofits employing, on average, 6.3% of the total paid workforce in these nations.³ On the lower end are countries such as the UK (5.4%), France (5.9%), and Germany (6.1%), while Belgium (9.9%), Netherlands (10.3%), and Ireland (9.4%) are on the higher end.⁴

Comparable employment data from developing countries is not easily available, partly because of the substantial presence of the informal economy. However, an earlier study by Salamon et al. reports that out of a set of thirty-six countries (that included both developed and developing countries), the average share of paid nonprofit employment overall among the total workforce was 2.7%, with developed countries having a higher average, at 4.7%, and for developing countries a lower average, at 1.2% [1].⁵ This data may not, however, fully reflect the growing importance of NGOs (nongovernmental organizations) in developing countries, whether in terms of people employed by them or in the range and scale of their activities. These organizations have been increasingly supplementing (and sometimes replacing) government agencies in the provision of relief and welfare, social services, and various development projects in

¹ See Salamon and Sokolowski (2018a) for a discussion of how to characterize this sector and the range of organizations it includes [29].

² See [30].

³ See [31].

⁴ If we use the public sector as a point of comparison, about 15.3% of the workforce in the US are employed there, with the corresponding numbers for the other countries mentioned here being 16.4% in the UK, 21.4% in France, 10.6% Germany, 18.4% in Belgium, 12.8% in the Netherlands, and 15% in Ireland (See [32]).

⁵ This earlier study reports numbers for the period 1995–2004. For the specific countries we mentioned latest numbers for – the US, UK, Germany, France, Belgium, Ireland, Netherlands – the earlier numbers are comparable but a bit lower suggesting growth in the subsequent decade.

such countries. Over the course of the 20th century, the number of international NGOs rose from under 200 in 1909 to just short of 1000 in 1956, increasing to over 20,000 by 2005 [2].

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, it becomes a challenge to model its behaviour. 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 actor of economics textbooks (often referred to as *homo economicus*) will pursue a non-pecuniary objective? 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? For example, one might think that an organization may not afford to be as “pro-social”, even if that is what the employees and management wants, if there is competition from other organizations (e.g., schools and hospitals).

Second, the existence of nonprofits calls into question the neat division of economic activity between the two spheres of the market and the government. Instead, it suggests that there is a grey zone, with actors who are not operating purely either in (a) a profit-driven private sector that produces private goods efficiently, or (b) a public sector that corrects market failures, provides public goods, and carries out redistribution to serve equity objectives.

Even in mainstream economics, some scholars are questioning the traditional views as to the motivation of economic agents, as well as the simplistic model that equates for-profit firms with the production of private goods and government entities with the provision of public goods.

The assumption that individuals are driven by narrow self-interest has been subject to increased scrutiny. Both experimental and theoretical economics are recognising that assuming the motivation of individuals, even in standard economic domains (e.g., the workplace), as driven by narrow self-interest is flawed and that a broader range of motivators must be considered. These encompass more pro-social motivations, such as a person’s sense of identity as an ‘ethical’ person, the need to cohere with an ‘in-group’ or social norms, and pure altruism, among others.⁶

No longer is it possible to evaluate the pursuit of the public good through analysing government agencies alone. The increasing importance of private social-sector organizations, including those motivated purely by the public good, such as nonprofits and NGOs, as well as hybrids such as public-private partnerships, means equating acting for the public good solely with government agencies is too narrow a perspective.

Relatedly, another trend is questioning the division of economic activity between the markets and the government service [3]. The traditional belief that markets are the most efficient way of producing private goods, while the government provides public goods and services and corrects market failures is no longer tenable. Governments do not always pursue the public good, being susceptible to failings such as corruption and poor service quality, while self-regulating markets do not always fulfil the utilitarian objective of the greatest good for the greatest number, as the 2008 financial crisis clearly demonstrated, and as the climate crisis continues to demonstrate.

A large amount of literature on the economics of nonprofits has emerged since the early 1970s (see [4] for a review), and this literature addresses alternative theories of nonprofits that will be reviewed in the next section (Section 2). This paper argues that while 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. Section 3 discusses the rise of social enterprises and provides some examples. Section 4 discusses a new agency problem that this author calls the “mission-integrity problem.” This concept is an extension of the multi-tasking 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 the analysis focuses on the interaction between the selection of pro-social individuals in the social sector and the mission-integrity problem. Section 5 discusses the self-selection of motivated managers into social enterprises. Section 6 will offer some concluding observations on the emerging research agenda relating to the social sector, both from the economic and policy points of view.

2. Existing theories of nonprofits

For most firms, the profit motive underpins their operations. They are incentivised to produce the highest quality good at the lowest possible cost, and so gain market share. It is this principle that explains why markets are seen as crucial for the efficient production of private goods and services. However, where the quality of the goods or services cannot be effectively assessed by the consumer, this creates the risk of what Hansmann called ‘contract failure’ [5]. In such

⁶ 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).

circumstances, a private firm that is incentivised to maximise profits may cut costs at the expense of quality, leading to low-quality goods or services being produced and as a result the market outcome would be inefficient.⁷

Nonprofits are a potential solution to this failure. This is because nonprofits are limited by a ‘non-distribution constraint’ (NDC) which prevents profits from being distributed to the owners, investors, or other controllers of nonprofit. Instead, it is required to be reinvested into the nonprofit, distributed to beneficiaries in some form, or given to employees who – crucially – do not have control rights.

Suppose the quality of a service can be high or low, but it is not directly measurable or observable to the consumer. To produce higher quality, a firm must incur higher costs. As quality cannot be directly observed or measured, only a single price can be charged for this service. If price does not depend on quality and choosing a higher quality entails a higher cost, profits would be lower. As a result, in a for-profit firm, there would be a tendency to cut quality in order to lower costs. 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 [6].

A NDC, therefore, is a mechanism that ensures managers have a reduced incentive to compromise quality since they cannot pocket financial profits directly.⁸ However, the literature also 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 non-contractible quality, they also have little incentive to cut costs in socially productive ways. In this respect, for-profit firms are preferable.

This is a simple illustration where the cost-quality trade-off results in contract failure. However, the argument is more general. It also holds when, instead of quality, what the firm is choosing between are actions that are socially beneficial (e.g., pro-environment) but costly vs those that are commercially more attractive. For firms faced with a choice between a pro-social action and a commercial action, for-profits tend to choose the latter course, and nonprofits the former.

There is significant evidence to support the implications of this argument in the context of both for-profits and nonprofits. Deming, Goldin, and Katz found that in the US higher education sector, where for-profit colleges have been the fastest growing part of the sector from the 1990s to 2010, for-profits are likely to provide a lower quality service [7]. Students at for-profit colleges are likely to be charged more in tuition and fees and are more likely to end up unemployed than their counterparts at nonprofits and public sector colleges, which suggests a difference in the quality of education.

A more contemporary issue is that of academic publishing. For-profit publishers are often criticised for their subscription charges to libraries of academic institutions, especially given that their content is provided, reviewed, and edited by researchers at those self-same institutions. To the extent that access is a desirable aspect of goods of quality, for-profits create a distortion. In some industries and fields, this is not harmful, but the Covid-19 pandemic has highlighted a particular problem with accessing academic research that has a direct bearing on public health and public policy dealing with the crisis. As Dhar, Brand, and Bertozzi identify, there has been a huge volume of work conducted into Covid-19, with pressure on academics and publishers to publish quickly [8]. For-profit publishers, under this pressure, coupled with financial incentive, are not the most suitable publishers for this type of work. Alongside this, the peer-reviewed system that operates on the basis of academics voluntarily giving up their time is too sluggish and laborious, highlighting the need for rapid, transparent peer review that maintains standards and accountability. To this end, Dhar, Brand, and Bertozzi argue that nonprofit philanthropic organisations are best able to fund improvements in how science is curated, reviewed, and published to meet these challenges.⁹

However, the NDC is not the only mechanism that governs the behaviour of nonprofits. For example, one has to keep in mind the role of market competition as an incentive device as well. In certain sectors where nonprofits and for-profits directly compete, how differently do nonprofits behave? Evidence from the US healthcare system suggests that they may imitate their for-profit competitors, with nonprofit hospitals in for-profit intensive areas significantly more responsive to financial incentives arising out of regulatory changes than their counterparts in areas served by few for-profit providers [9].

The economics literature on nonprofits has placed relatively little focus on the motivation of those who manage or work in such organizations, with Handy, Preston, and Weisbrod being some of the few exceptions [10, 11, 12]. Such individuals are often found to differ little in terms of pro-social motivation from the general population,¹⁰ with the effectiveness of nonprofits often closely related to the nonprofit’s ability to attract employees who are committed to a cause, as noted by Preston, Weisbrod, as well as Besley and Ghatak [11, 12, 13]. This ability may influence the choice of organisational form, particularly in relation to credence goods, where quality cannot be effectively evaluated by the

⁷ Technically speaking, we are referring to credence goods (e.g., health service, legal advice, and childcare). For such goods, the utility cannot be judged well by the consumer even after consumption. This is different from experience goods, where quality is hard to judge before consumption but is revealed reasonably clearly after buying and consuming (e.g., jobs, houses, hotels and restaurants, plumbing, cultural products like films and music). For experience goods reputational mechanisms and some contractual warranties usually work well to assure a minimum level of quality.

⁸ The risk of opportunistic behaviour manifesting itself is not, however, completely mitigated by putting in place NDCs. Salaries and perks provide a mechanism through which managers and involved parties can extract some of the surplus (see [6]).

⁹ They provide the example of MIT Press that made a selection of relevant e-books and journal articles freely available and also developed a new, rapid publication model for books, under the imprint First Reads to address the need for the rapid dissemination of COVID-19-related research.

¹⁰ See [33] for a discussion.

consumer. Such a relationship – between employee selection, incentives, and organisational form – has received little attention, but as argued here, it might provide important insights about the emergence of new organizational forms in the social sector, such as social enterprises.

3. Emergence of social enterprise

The rise of social enterprises in recent decades means organisations cannot be classified discretely into nonprofit, for-profit, or government entities. This reveals a basic limitation of the contract failure literature which assumes organisations can take either for-profit or nonprofit forms alone. Social enterprises exist between the two, being neither traditional profit-maximizing firms, nonprofits, or government agencies.¹¹ These hybrid forms of organization are often referred to as “social enterprises” even though, as Martin and Osberg acknowledge, many other types of firms operate under that banner [14].

The defining goal of a social enterprise is to balance making profits with pursuing a social mission [15].¹² As Dees puts it, they 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.” [16] 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.

Having social objectives is not the sole preserve of social enterprises and nonprofits. Most organisations have multiple objectives, with the key issue here being which should take priority and when they should take priority. In for-profit firms, the demands of the market mean that they must prioritise profit maximisation while respecting certain social objectives, which are often externally imposed, like environmental standards. Nonprofits, equally, must still seek to break even and adhere to the NDC, while prioritising social ambitions. Social enterprises are more flexible, at times maximising the social objective, albeit subject to the break-even requirements, while at other times prioritising a financial objective, while still ensuring they do not fall below certain standards in delivering their social objective.

Therefore, social enterprises pursue profit and social good in tandem, shifting their focus depending on circumstance [17]. Social enterprises counter the challenges faced by nonprofits (in that they cannot distribute profits and so are unappealing to prospective entrepreneurs seeking to blend equity finance with social goals), and by for-profits (in that managers there have a legal obligation to maximise profits, and a practical obligation in that profits are necessary for investor confidence).¹³ This is primarily done through social enterprises being permitted to earn revenue, but without constraints like an NDC. Instead, the constraint is the need for the social enterprise to align its activities with its social mission. For these social entrepreneurs, this 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.” [16].

As social enterprises have become more prevalent in the real-world they have been subject to more academic analysis and commentary, particularly in terms of how successful they have been in overcoming the challenges of the for-profit and nonprofit organisations. There have been innovative companies founded in this model, seeking to benefit the public good while being financially profitable, as in the examples below:

Lendstreet Financial helps reduce indebtedness among low-income people by delivering financial literacy programs incentivising responsible repayment [18]. Prior to delivering these services to a new client, Lendstreet purchases their debt from one or more institutional investors, and when clients increase their rate of repayment, Lendstreet earns revenue.

In Africa, where children frequently die of diarrhoea from bad sanitation, Isaac Durojaiye runs Dignified Mobile Toilets, 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% of the income and pass the rest to the company, which uses the money to buy new toilets.¹⁴

Easy Being Green, run by Nic Frances, aims to cut carbon emissions in 70% of Australian households over 10 years, with ambitions to expand globally.¹⁵ They give low-energy light bulbs and low-flow showerheads to households that sign over the rights to the carbon-emission credits that using the equipment earns. These credits are then sold to companies with the proceeds used to finance its activities.

¹¹ Although it should be acknowledged that many other types of firms, as well as social enterprises, operate in this manner [14]. Terms like public benefit corporations [34] B Corporation [17], social enterprise [16], [35], social business [36], and community interest company [17] are part of an emerging lexicon, but all stand for somewhat different organizational forms.

¹² By “mission,” I mean “objectives.” In the economics literature, “mission” is not a widely used term. Instead, individuals or organizations are said to pursue “objectives,” which can be financial (e.g., profit maximization) or social (e.g., a cleaner environment). However, 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.

¹³ See [17] 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, a key question focuses on how to solve legal disputes that occur when profit making and social purpose conflict [37].

¹⁴ See [38].

¹⁵ See [38].

Battilana et al. give the example of Hot Bread Kitchen, a New York City bakery that offers a novel range of breads while also being an award-winning workforce development program [19]. It mostly employs low-income immigrant women who bake goods from their native countries, while learning skills that help them secure management positions in the food industry. This enables Hot Bread Kitchen to combine a social mission of workforce development with a commercially viable model.

They also discuss Embrace [19], an organization that aims to commercialize a low-cost incubator for premature infants. Although it started as a nonprofit, Embrace created a for-profit arm to overcome the financing constraints of expansion. The nonprofit arm owns equity in the for-profit side, allowing the ability to monitor the commercial arm's adherence to the social mission.

There are examples of hybrid organizations, too – organizations that have one arm that is for-profit with another arm, a nonprofit one, exercising control over the former. Altrushare Securities is a brokerage firm that acts much like a Wall Street outfit, buying and selling stock and providing research on companies. However, Altrushare is majority-owned by two charities, who each control 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, CT. “What makes us different is our nonprofit ownership and our mission, which is to support struggling communities with our profits.”¹⁶

All these are examples of organizations which have a clear social objective and yet are not organized as nonprofits. The main advantage is the flexibility that this offers, relaxing the constraints imposed by the NDC. This includes accessing sources of finance beyond debt, such as equity (nonprofits cannot distribute profits and therefore, cannot issue equity).

A key question that the emergence of social enterprises raises is how they can guarantee striking a balance between their social mission and commercial objectives, overcoming the tension between the two. Do they indeed stick to their social mission or does the flexibility imply that they act indistinguishably from a for-profit firm, despite having lofty objectives on paper? This is not just a theoretical possibility. For example, in the commercial microfinance sector, the social mission of relaxing borrowing constraints of the poor comes head-to-head with profit-seeking that may occur at the expense of the poor, raising the spectre of “mission drift” [20]. Besley and Ghatak call this the “mission-integrity problem” [21].

4. The mission-integrity problem

What nonprofits, social enterprises, and other hybrid organizations discussed have in common is that they are all mission-driven organizations, where ordinary pecuniary motivations are often not present, and outputs cannot be measured in such a way to make ordinary incentive contracts effective. In some cases, these outputs are purely private goods – i.e., the costs and benefits relating to the production or consumption of the good or the service accrue to the direct consumers or users and producers or service-providers only (e.g., health care with no externalities, such as treatment of non-infectious diseases, or commercial research). In other cases, the outputs also have a public-good component, namely, benefits that accrue to those who are not direct users. For example, better environmental standards benefit the public at large and not just those who work in a particular firm or use a particular product. Also, the public-good component could arise from shared social values about justice or fairness, for example, directly ensuring a minimum provision of certain goods (e.g., basic health care, education, helping the poor).

The conflict that is at the heart of social enterprises – between their mission to fulfil social goods and pursue profit – means that they need a mechanism that can balance the competing objectives while ensuring the broader mission is maintained. This ‘mission-integrity’ problem can be seen in the following example: Suppose the manager has a choice between a pro-social and a commercial action. The pro-social action has a social benefit but is also costly, while the commercial action has no social benefit but has lower cost. Here, there are two key types of situation that can arise. In one, social considerations outweigh financial considerations, and so taking the pro-social action is the right thing to do. In the other, financial considerations outweigh social considerations, and so the commercial action is the correct course. Suppose it is possible to verify whether a manager has undertaken the pro-social action or the commercial action. However, only the manager can observe the true facts of the situation; 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.

There are several circumstances that would fit this scenario.

Consider first situations in which the goal is to widen access to certain goods or services: education, health care, and legal services are important examples. Now, the pro-social action can be interpreted as providing access to “deserving” beneficiaries at preferential terms (e.g., free treatment for the poor) while the commercial action involves offering no special access or concessions. For example, suppose the choice is between admitting a poor but meritorious student in a college but having to forego the tuition fees vs admitting a student from an affluent background who can pay full

¹⁶ See [39].

fees but may not be as talented. The manager may observe an individual who is to be served (say, a patient, student, or a potential beneficiary of a targeted welfare program) and decide what action to choose.

Second, 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 pro-social action is to use a costlier but more environmentally sound technology. The manager must decide whether the external environmental benefits are substantial enough to warrant sacrificing profits.

To the extent the manager makes choices in different situations based on information that only he or she possesses, how 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.

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, commercial considerations are irrelevant, and the manager is expected to always choose the pro-social action. However, this creates the risk of inefficiency when the commercial considerations should outweigh the social.

For-profit firms also have a rigid mission – to maximize profit. Any deviation from profit maximization would pose an agency problem, even if for the worthiest of social goals [22]. Such a binary fails to recognise that social considerations sometimes outweigh commercial considerations. In this scenario, for-profit firms generate a negative externality.

The rigidity that characterises these two entities therefore has a downside, in that it fails to enable the pursuit of an alternative priority when the circumstances warrant it. This rigidity is what social enterprises seek to mitigate, but this raises a new challenge – how do they guarantee mission integrity [23]?

In the absence of contractual solutions, the mission-integrity problem creates a role for what Katz and Page call “mission-sympathetic parties” who are appointed to achieve an optimal trade-off between commercial and social considerations [15]. When individuals care about the mission of an organization, they will care about whether the organization is indeed committed to that mission. This argument is formalised by Besley and Ghatak [21], who show that by hiring managers sympathetic to the social mission, and giving them a financial stake in the organisation, this incentive structure will ensure they ‘do the right thing’ in the circumstances. In other contexts, using stakeholders as external monitors may also 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 by the social mission, nonprofits and social enterprise are equivalent, as managers of this type will always prioritise social objectives over 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.

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 – reflecting a trade-off between quality (or social goals) vs profits – that has been a primary focus of the existing literature on nonprofits. It points out that an important dimension is also whether there is flexibility in making this choice or not. 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 due to 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 pro-social 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 that the only social responsibility of business is to make profits [22]. What this implies is – to the extent individuals have different views on what may be socially desirable, and given organizations cannot achieve perfect alignment of these preferences among its employees – for-profits will be the dominant organizational form. Only when the social benefits are large, can one expect organizations to form that draw in individuals with views that are aligned in terms of the importance of the mission.

5. 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 noted above, the potential role of nonprofits in attracting moti-

vated managers is recognized [12], the formal theoretical literature on nonprofits has not explicitly considered the role of intrinsically motivated managers and how their presence and selection interacts with underlying agency problems. A key insight of the Besley and Ghatak 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 [21].

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 non-pecuniary motivation and care only about money and their disutility of effort. As a result, nonprofit status are seen as necessary to manage the trade-off between cost and quality or profits and social goals. Once we allow for managers who have non-pecuniary motivation, nonprofit status ceases to be a necessary condition for aligning commercial and social objectives. Allowing for pro-social motivation therefore opens the door to more-flexible organizational forms, such as social enterprise.

However, a further 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 could 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 labour 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” [23]. 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 [24].

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 attract the right kinds of people?

In nonprofits, the incentives are right for selfish managers, while in social enterprises the incentives are right for motivated managers. 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).

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?

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 labour 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 labour demanded by nonprofits is driven by “motivated types” sorting into nonprofit jobs who are willing to take a wage cut [25]. There is 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 [26]. There is also evidence that measures of pro-social motivation predict the decision to work in the nonprofit sector, and that workers in this sector accept a wage discount for that reason [27].

6. Concluding remarks

Much emerging research in this 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, labour) or into a standard framework that applies to government entities providing public goods (e.g., standard public economics).

However, 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 goods and services have externalities: That is, their benefits or costs are partly external to the organization that provides them. According to Coase the inefficiencies that arise from externalities have to do with the difficulty of creating property rights [28]. 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 non-contractible, 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 discussed – the kinds of problems that have traditionally been the focus of public economics – is non-contractibility, namely, when the output is difficult to measure and price. If non-contractibility is not the issue and output is measurable, then non-rivalry (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. As mentioned earlier, one advantage of social enterprises over nonprofits is that the former can raise equity while the latter can only incur debt. At the same time, for-profits cannot offer the same tax benefits to donors as registered nonprofits. As seen in the examples provided in section 3, some hybrid organizations create two separate legal entities, one a for-profit and one a nonprofit, to try to overcome these problems. Other than selection of motivated managers, as discussed above, the ownership of equity stake by the nonprofit entity of the for-profit suggests an additional mechanism for ensuring mission-integrity. Another important area of future research related to the continuum of organizations that spans social enterprises of various kinds to nonprofits, is public policy (e.g., tax, subsidy, regulation) regarding these organizations. These include questions about whether existing laws and regulations applying to for-profits and nonprofits that govern various aspects of these two sets of organizations need to be adapted to fit this growing but somewhat amorphous sector? How does one make sure that the social enterprise or the hybrid organization is pursuing the stated social goals given that flexibility is at the heart of their emergence? This in turn raises important questions about how to measure social impact and its compatibility with the stated mission.

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Competing Interests

The author has no competing interests to declare.

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