What Should Social Investors Invest in, and With Whom? (WIMPS, 9/4/12)

A Last Minute Я Us Production
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What am I talking about

• Social Investment = Invest in Social Enterprise
• Social Enterprise = Produce Social Goods
• But what’s the definition of social goods?
  – “[S]ocial enterprise provides, or tries to provide, things that society values but which for one reason or another are not usually provided by private enterprise. In most cases, this is because the social value of an activity is not easily captured by the price or financial return for the service or good offered. Social enterprise seeks to apply business principles and skills to create greater social value.” (Horton, 2008)
Such as?

• Goods subject to market failure due to
  – Collective consumption
  – Nonverifiable Quality (contract failure)

• Merit Goods
  – Goods that consumers place too low a value on, according to a paternalistic standard
  – Social Marketing and Advocacy are examples

• Affordability
  – Redistributive Provision of Private Goods
Coming Attractions

- Government as a Social Investor
- The Case for Social Investment in Nonprofit Organizations
- The Case for Social Investment in For-Profit Organizations
- Hybrid Organizations
  - L3Cs, CICs, B-corporations, Benefit Corporations, Social Impact Bonds, nonprofit or for-profit subsidiaries
- Evaluating Hybrids
  - Efficiency
  - Access to Capital
  - Contract Failure
  - Sustainability of Mission
- Caveat: No analysis of cooperatives, mutuals, etc.
Government

• Does lots of social investing
  – Directly
  – Contracting Out
  – Regulations force private social investment

• Limited by political forces
  – Constrain fiscal capacity as well as investment targets.

• Government should not do it all
  – Virtue of Pluralism, fostering voluntary impulse
  – Private social investments in Governments (e.g. Carnegie)
The Case for Nonprofits I

• Social investors invest in nonprofits through
  – Grants, Donations, Volunteering, In-kind donation, loans (PRIs)
  – Paying a premium for goods and services

• Nonprofits provide collective consumption goods
  – For-profits don’t provide nonexcludable collective goods unless paid to do so
  – Donations to for-profits are not made because of marginal-impact contract failure
The Case for Nonprofits II

- Nonprofits suffer less from contract failure
  - For-profits have incentive, opportunity, and threat of takeover pushing them towards delivering less than promised quality
  - Nondistribution of profits reduces the incentive
  - Nonprofits are not restricted by the market for corporate control
  - Those that choose to govern and control nonprofits are (arguably) not interested in delivering less than the promised quality or quantity, particularly the volunteer board.
  - There are other reasons why “nonprofit” doesn’t fully solve the problem.
The Case for Nonprofits III

• Nonprofits provide merit goods
  – In areas of social marketing, religion, advocacy
  – Using messages and price subsidies
  – Private nonprofit paternalism is less objectionable than public governmental paternalism
  – Sometimes for-profits do this equally well. E.g., Nicotine patch producers push people to quit smoking.
  – But for-profits are not as good if profit distribution leads the public to question the sincerity and credibility of the effort. E.g., for-profit religion.
The Case for Nonprofits IV

- Redistributive efforts are made by both for-profits and nonprofits
  - Sliding scale fees
  - Financial aid
- But they serve different purposes
  - For-profit: price discriminate in order to convert consumer benefits into producer benefits
  - Nonprofit: price discriminate in order to serve redistributive mission and/or cross-subsidize mission-related goods
The Case for Nonprofits V

• So the patterns of price discrimination differ
  – For-profits don’t offer prices less than marginal cost. Nonprofits offer charity care and prices below costs.
  – When customers are willing to pay a price above costs,
    • For-profits exploit that to the maximum feasible extent.
    • Nonprofits exploit that to a lesser extent.
  – Increased social investment
    • reduces nonprofit prices and increases the share of low-willingness-to-pay consumers who are offered an affordable price (Starke, 2012).
    • Has no effect on for-profit pattern of prices.
The Case for For-profit Social Enterprise I

– Invisible Hand: If all goods are traded in perfectly competitive markets, then equilibrium is socially efficient.

– Missing Fingers
  • If – then. Real world isn’t that way. Collective goods and “the quality promised” are not traded
  • Social efficiency says nothing about affordability
  • Social efficiency is non-paternalistic
The Case for For-profit Social Enterprise II

– Other Fingers
  
  • productive efficiency (resources are directed where they are most productive)
  
  • scarce capital allocated to the most profitable goods.
Profitable Social Enterprise I

• Corporate Philanthropy/Corporate Social Enterprise models generalize to all kinds of profitable social investment, by either NP or FP
  – Enhances revenues
    • if consumers are willing to reward the differentiated product sufficiently
    • If SE forestalls boycotts (Baron 2009)
Profitable Social Enterprise II

– For joint production of a private and collective good.
  • Can reduce costs or enhance revenues
  • Fair trade coffee, less-polluting production, sheltered workshops for production by persons with disabilities
  • NP: Posnett and Sandler, 1986
  • FP:Bagnoli and Watts, 2003; Kotchen, 2006; Besley and Ghatak, 2007
Profitable Social Enterprise III

– Reduces Labor Costs
  • Executive recruiting and turnover costs are lower
  • So is financial compensation (because some compensation is “dividends in kind”, warm glow)
  • Willingness to accept lower financial compensation serves as a screening device for morally-motivated workers. Reduces the principal agent problem. (Brekke and Nyborg, 2004)

– Forestalls costly regulation and legislation.
Models of Social Investors I

• SIs buy shares in profit maximizing and CSR firms and also Donate
  – Profit-maximizing firms distribute all profits as dividends
  – CSR firms divert a portion of profits to charities
  – Investors are diverse in relative preference for direct vs. indirect donations

• Expected diversion of dividends lowers the initial share price.
  – The rate of return for outside investors is unaffected by diversion
  – The initial entrepreneur bears all the costs.
Models of Social Investors II

• Crowdout occurs between direct and indirect donations.

• Nonetheless, total social investment is higher with CSR firms than without.
  – Lower share price increases total investment.

• Graff-Zivin and Small (2005), greatly extended by Baron (2007).
Social Investment and the Market for Control I

• Friedman (1970): “[If a manager engages in CSR] will not the stockholders fire him? (Either the present ones or those who take over when his actions in the name of social responsibility have reduced the corporation’s profits and the price of its stock.)”

• Extreme, but to be sustainable, CSR firms must have protection from the market for control.
Social Investment and the Market for Control II

• Market for control is limited by varying legal structures, information problems, collective action problems, anti-takeover strategies.
  – Hence some unprofitable CSR takes place in the interests of managers who want to help or want prestige.
  – Hence real for-profits depart from social efficiency in other ways. Cronyism, Excessive risk taking, Excessive executive pay
Limitations on For-Profit SE I

- Amount is limited
  - Despite consumer willingness to pay higher prices, competition limits the ability of this to finance CSR. (Bagnoli and Watts, 2003)
  - Crowdout of direct donations occurs
  - Entrepreneurs willing to bear the full burden of expected CSR are scarce

- Generally targeted at noncontroversial causes.
Limitations on For-Profit SE II

• Mission sustainability challenged
  – Market for control makes long-term sustainability less likely.
  – Double-bottom lines suffer from mission drift and create internal conflicts that reduce efficiency – particularly when ownership changes.

• Contract failure occurs
  – Greenwash – selective reporting
  – Marginal impact and nonverifiable quality contract failure.
Example: Newman’s Own, Inc.

- Privately held for-profit, started by Paul Newman
- All after-tax profits to Newman’s Own Foundation.
- Sustainable
  - Til he died – he was the sole investor.
    - Not willing to sell control.
  - When fatally ill – sold all shares to foundation.
    - As sustainable as any nonprofit mission
  - Generalizable?
    - If multiple investors needed, profit-seeking investors have incentive to pretend agreeing with Newman’s goals.
    - “The appetites and desires of owners can shift and even closely-held and unincorporated business forms are business forms. If a set of owners come, over time, to favor profits over social goals, it will be hard to constrain them from voting their preferences.”
New Hybrids

• Goal: An organizational structure that is efficient and has full access to capital while sustaining a social mission in a trustworthy manner.

• Forms (so far)
  – traditional LLC (limited liability company)
  – L3C (low profit limited liability company)
  – CIC (community investment corporation)
  – B corporation (privately certified)
  – Benefit Corporation
  – Social Impact Bonds
Hybrid Features

• Multiple classes of shareholders (e.g., L3Cs have an equity tranche, receiving no dividends but having a controlling governance interest, a mezzanine tranche, receiving limited distributions, and a senior tranche receiving market rate distributions, in either debt-like or equity-like form)

• Asset locks on conversion/sale (CIC, but not L3C)

• General restrictions on dividends (CIC)
Hybrid Efficiency I?

• If it occurs, it isn’t for the reasons why for-profits are efficient
  – Restricted distributions – removes the financial incentive to cut costs in regular for-profits
  – Restricted governance rights – removes the ability to cut costs
  – Restricted market for control – no takeover threat
• But the for-profit efficiency argument is exaggerated
  – Invisible hand gets to equilibrium through failure of inefficient for-profits. Since many inefficient for-profits are “not dead yet”, average for-profit is inefficient.
  – Too big to fail firms are protected from the invisible force.
Hybrid Efficiency II?

• And the nonprofit reason for efficiency is retained
  – Caring about mission, dividends-in-kind, collective goods as team incentives.

• But costly fighting among stakeholders with contrary missions reduces hybrid efficiency.
Hybrid Access to Capital

- The overall rate of return is below market
  - So senior tranche needs to be cross-subsidized by other tranches to receive a market rate
  - Ability and desire of social investors to cross-subsidize is limited (L3Cs and SIBs)
  - L3Cs are thought more able to attract Program Related Investments (loans from foundations), but esp. with proposed new IRS regs, L3C status is neither necessary nor sufficient.
  - Investors willing to forego dividends are limited (CICs). Their doing so may come at the expense of direct donations.
Hybrid Contract Failure

• Nondistribution by stakeholders in control would suffice, but lack of asset lock (L3C, but not CIC) makes that less meaningful.
• Although senior tranche lacks *de jure* control, a resource-short hybrid would have to grant some *de facto* control to profit-seeking investors.
Hybrid Sustainability

• Some missions can be accomplished once and for all. No need of sustainability here.
• B corporation – could change at any time
• L3C – could revert to LLC any time
Conclusion

• “Like Dr. Doolittle’s pushmi-pullyu, the animal that had trouble moving because its two heads could not agree on a single direction, the hybrid model for nonprofits is proving problematic. On occasion, the need to generate returns for investors overwhelms the social mission. In other cases, the business falters altogether and cannot support the nonprofit. “(Strom)

• “The two invaluable contributions a hybrid form must make – expanding financing options and providing enforceable commitments to a blended mission – appear to trade off against each other. It is possible that the impasse cannot be breached.” (Brakman Reiser)

• Don’t give up yet on hybrids, but be “vey vey vewy caweful” (Fudd).