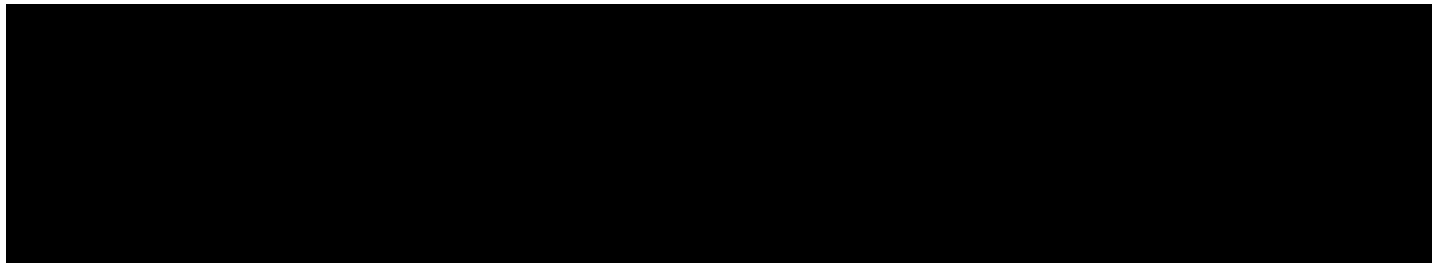


London School of Economics

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# Introduction



Economists have adopted a simplifying strategy that goes back at least to John Stuart Mill (1867) "[Political economy] does not treat of the whole of man's nature . . . it is concerned with him solely as a being who desires to possess wealth, . . . it predicts only such . . . phenomena . . . as take place in consequence of the pursuit of wealth. It makes entire abstraction of every other human passion or motive."

This strategy involves three assumptions

Separation between markets and the government (aggregate level)

Markets are the most efficient way of producing private goods but not for public goods (or mitigating public bads) where appropriate



Individuals have preferences over various occupations, effort levels (as workers), goods and services (as consumers), investment opportunities (as investors)

For example, a worker may have a lower cost of effort when he is working in a task he likes - intrinsic motivation

Money (wages, prices, returns) also affects the choice of individuals to work, buy, or invest

These can be treated separately - if someone pays you to do something you like to do anyway, then you do it even more

More formally, intrinsic and extrinsic motivation are substitutes







# Social Enterprise

There has been a large literature on the economics of nonprofits since the early 1970s (e.g., Hansmann, 1987) that provide a convincing explanation of why the organizational form of nonprofits may be a constrained efficient solution to some underlying contracting problems

However, it does not provide an obvious framework to explain the rise of more hybrid forms of organizations in the social sector, often called social enterprise, which cannot be fitted into the simple partition of the economy into for-profit, non-profit and government organizations.

These are more flexible forms of organizations and combine features of both nonprofits and for-profits.

# A Conceptual Framework

We start with the cost-quality trade-off as a canonical model of contract failure that lies behind existing theories of nonprofits

Discuss the rise of social enterprise and provide some examples of these "dual-mission" organizations

Provide a theoretical framework where managers with pro-social motivation can overcome the rigid mission problem of both for-profits (objective is to maximize profits) and nonprofits (do not maximize profits)

# Cost-quality trade -off

Suppose the quality of a service can be high or low, namely,            or            but it is not directly measurable or observable to the consumer.

# Cost-quality trade -off

If this is a for-profit firm, then choosing low quality would yield a profit of  $\pi_L - c_L$  (which we denote by  $\pi_L$ ) which is higher than the profit if high quality is chosen instead, namely,  $\pi_H - c_H$  (which we set to 0 for simplicity).

If this is a non-profit firm, then the manager or owner does not directly benefit from the cost savings that arise from lower quality and will therefore have no incentive not to provide higher quality.

This is a very simple illustration of a cost-quality trade-off, which is an example of contract failure.

# Mission Integrity Problem

Besley-Ghatak (2017) propose the mission integrity problem as a generalization of the multi-tasking problem that is behind the cost-quality trade-off

Suppose it is possible to verify the action of the manager, namely whether the pro-social or the commercial action was undertaken.

The problem is, suppose now there are two types of situations that can arise.

Sometimes social considerations indeed outweigh the financial consideration and so taking the pro-social action is the right thing to do.

However, in other situations, financial considerations may outweigh social considerations and there, the commercial action is the appropriate one.

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