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## **The Economic Rationale Behind the Social Business Model:**

### **A Research Agenda**

Alejandro Agafonow and Cam Donaldson

#### **ABSTRACT**

This article's purpose is to set out the economic rationale that underpins social businesses, engaging in a research agenda's conceptual development on hybrid firm ecosystems. A different form of business is needed to prevent dividend-distributing companies from abusing the market power allowed by barriers that keep competitors away at the expense of the poor. Thus, bottom-up development strategies have limits if solely based on dividend-distributing companies. An alternative is offered by social businesses, but these are difficult to theorise within the constraints of Pareto optimality. In exploring alternatives to the latter, this article posits that, despite shortcomings, there are neoclassical contributions that provide a basis for researching social businesses, which can be understood and modelled as companies maximising worst-off customers' well-being.

Keywords: social business, Muhammad Yunus, hybrid firms, Pareto optimality, bottom of the pyramid, development.

## INTRODUCTION

This article is the result of an effort to understand how social business fits into today's economic science. While economic science generally endeavours to understand how for-profit, dividend-distributing companies, as well as the public sector and donative non-profits, drive the allocation of resources in a market economy, this article asks to what extent the economic science of today can also serve for researching non-loss, non-dividend companies dedicated to the achievement of social goals, also known as social businesses. It is submitted that the future of a research agenda on social businesses lies in, first, shedding light on how to increase capital investment in social businesses while protecting the non-dividend constraint; second, better understanding the governance of social businesses and how the non-dividend constraint may prevent possible deviations from the social business's aim or objective function; and third, theorising possible new equilibria which depart from the maximisation of value capture on a financially sustainable basis.

Our enquiry starts by exploring some fundamental disagreements concerning bottom-up strategies of development, highlighting the limits that for-profits and, in particular, multinational corporations (MNCs) have when conceived as the most important drivers of economic development. Next we explore the limits of Pareto optimality in theorising hybrid firm ecosystems, which is where firms like social businesses actually operate. These are 'ahead' of theory and we point out some shortcomings of Pareto optimality when making room for this new research agenda. Neoclassical economics is not, however, totally barren in terms of understanding a social business, and we show how it can be productively put at the service of this research. To close, we suggest some lines of enquiry that can contribute to harnessing a new kind of capitalism, one that better serves humanity's most pressing needs.

## BOTTOM-UP APPROACHES TO DEVELOPMENT

Bottom-up approaches to development are in high demand. The idea that people living on less than \$2.50 a day can capitalise on economic opportunities to overcome their dire situation has gained currency in the last few decades. But however promising this might be, there is little consensus over the means best suited to attain the goal of poverty alleviation. Although a common feature of this research is the recognition that poverty is too complex a problem to be dealt with by the state alone, those advocating bottom-up approaches lack unanimity. At the heart of their disagreement lies the array of alternatives offered by the private sector, which – it must be remembered – does not rely only on profit motives. A social business, for instance, is a new form of commercial venture that lies somewhere between for-profit and philanthropy. Challenging the conventional wisdom of efficiency, businesses of this kind forgo dividend distribution – like charities or traditional philanthropic organisations – but retain the financial sustainability principle of conventional for-profit firms (Yunus & Weber, 2007, 2010).

However, some believe that the profit-maximising firm is the most useful mechanism to power bottom-up development. For-profits, MNCs in particular, are the best tools to unlock the wealth of developing economies, so the argument goes. This involves tapping into unexplored economic opportunities in unhampered market economies (e.g. Akula, 2008; Fitch & Sorensen, 2007; Hahn, 2008; Kistruck, Sutter & Smith, 2013; Ragan, Chu & Petkoski, 2011; Seelos & Mair, 2007; Webb, Kistruck, Ireland & Ketchen, 2010). At a time when MNCs face saturated markets at home, Seelos and Mair (2007) and Webb et al. (2010) consider MNC-NGO partnerships as a way of reducing the transaction costs of building

access to developing markets. At close quarters, Akula (2008) appraises the ability of for-profits to scale up business capacity in developing economies. The role played by public funds in helping businesses to profit in developing economies has been considered by Fitch and Sorensen (2007), while the protection of human rights when developing country governments fail in this area is explored by Hahn (2008). Kistruck et al. (2013) have also considered the use of identity-based mechanisms to increase sales in developing economies when agency costs are high, and Ragan et al. (2011) studied how the poor act as consumers, co-producers and clients.

Congruent with this literature, Garrette and Karnani (2010) maintain that a departure from shareholder wealth creation along the lines of a social business will jeopardise the achievement of scale which only free-market equity funding enables. Because investors in social businesses act as philanthropists, forgoing dividends (which are instead ploughed back into the business), social businesses are doomed to remain under-funded. In a similar vein, Kickul, Terjesen, Bacq and Griffiths (2012) stress the difficulty of social business governance in the absence of dividend distribution; according to them, the latter serves to reward superior performance. Also, Dees and Anderson (2003) warn against ploughing profits back, linking this practice to a cultural bias against profits.

It is important to emphasise that we have nothing against appropriating profits *per se*, as long as it takes place in a scenario that does not curtail the poor's freedom to choose. What seems to be missing in these accounts of the for-profit approach to bottom-up development is the fact that, since the market structure of developing economies tends to favour chronic supernormal profits that serve well economic elites rather than the population at large – termed *oligarchic capitalism* by Baumol, Litan and Schramm (2007) or *crony capitalism* by

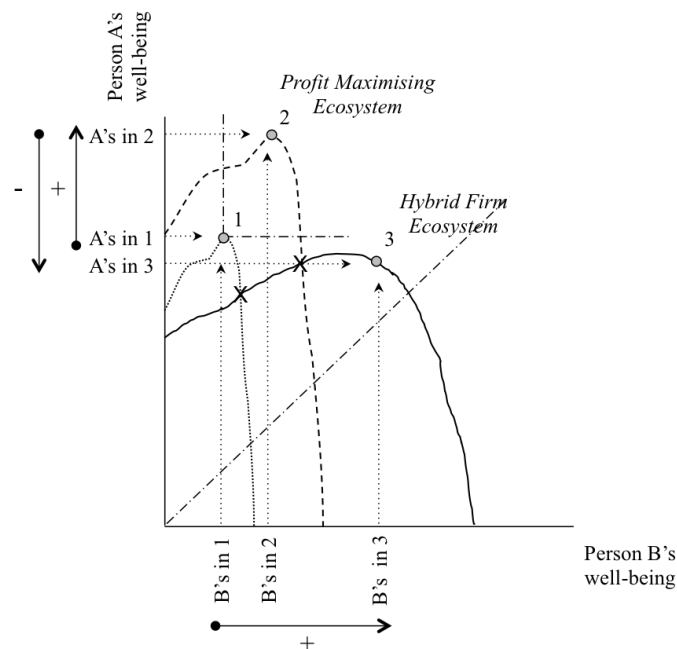
Haber (2002) – unhampered profit-making tends to worsen the dire conditions of the poor because, simply, they hardly have access to a wide array of consumption/production alternatives (Donaldson, Baker, Cheater, Gillespie, McHugh & Sinclair, 2011). It was exactly this that inspired the creation of the Grameen Bank, aimed at breaking into the financial market of the poor who were at the mercy of loan sharks (Yunus, 1998, 2007a, 2007b; Yunus, Moingeon & Lehmann-Ortega, 2010). So, in a sense we could say that too much profit-making in non-competitive markets is detrimental to capitalism.

A corollary of this is that there are other forms of private enterprises that can contribute to enriching a market economy's business ecosystem. These include the well-known non-profit organisations as well as cooperatives, but we are particularly interested in what a new kind of hybrid private firm, i.e. a social business, can offer in the context of a market economy. Since hybrid firms are being launched and run all over the world (consider, for instance, B-corporations, low-profit limited liability companies or L3Cs, and social enterprises), it seems that practice runs ahead of economic and management theory. Despite the anti-system critiques to mainstream economists' reluctance to conceive alternatives to capitalism, if market-based hybrid firms have any future, economics and management science may offer after all room for more creative thinking that, in addition to harnessing more sustainable business ecosystems, offer a basis for researching these new hybrid firms. Thus, the first proposition follows:

**Proposition 1:** If unhampered profit-making is related to the poor's freedom to choose, then, in the presence of market barriers, for-profits are likely to abuse market power reducing the poor's consumption and production alternatives.

## PARETO OPTIMALITY AND HYBRID FIRM ECOSYSTEMS

Figure 1 helps to illustrate the crossroads at which the current capitalist system stands. We are no longer part of the twentieth-century transition from capitalism to command economies. However superior market economies are to command economies, there is room for improvement in the current capitalist system. The question is whether such a change is conceivable within the body of thought of mainstream economics.



*Figure 1:* Social welfare functions illustrating the maximum amount of one person's well-being given the well-being attained by another in different business ecosystems (author's own)

The dotted-line hill shape in Figure 1 topped off with point 1 represents the current status quo, defined by person B's maximum well-being given the level of well-being obtained by person A. The distribution of well-being, whatever the metric used to measure it, is evidently extremely unequal. In order to conceive a transition to a different scenario, one must determine the mechanism by which collective decisions are made regarding choice of

direction. Twentieth-century economists followed Vilfredo Pareto in relying mostly on the market as the instrument of collective choice, although we know that people use other methods such as voting and consensus-building (i.e. dialogue and pacts) in parallel, however imperfect they might be. Pareto assumed further that no person would agree to a social change that implied a lowering of her position in the status quo. Thus, for a change to be feasible under these conditions, Pareto postulated what became known as *Pareto optimality* – that is, a departure from the status quo is possible only if at least one person’s well-being can be improved without detriment to any other person’s. If such a change were possible only at the expense of at least someone in society (let us say a king in a nineteenth-century European absolute monarchy), we would be already in the best possible scenario and, therefore, no reason for change would exist (Pareto, 1971, p. 261). A dismal outlook for human rights and democracy.

Thus, in graphical terms, Pareto optimality is compatible with a limited array of possibilities falling within the 90 degrees angle to the north-east of point 1. If we limit ourselves solely to Pareto optimal options, improvements to the current situation would only be possible by following the for-profit approach to bottom-up development sketched above, represented in Figure 1 by the segmented hill topped off with point 2. Given the structural problems associated with oligarchic or crony capitalism, any improvement to the current situation runs the risk of being only marginal for the worst-off – represented by person B on the horizontal axis, whose well-being in point 2 improved slightly compared to point 1. Because of the market barriers that get in the way of the poor’s freedom to choose, most of the benefits run the risk of being captured by the wealthy – represented by person A on the vertical axis.<sup>1</sup>

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<sup>1</sup> In the twentieth century the *Kaldor–Hicks efficiency criterion* was proposed to tackle the inherent immobilism of Pareto optimality. Thus, progress could be compatible with the latter



Unfortunately, Pareto optimality rules out scenarios involving more equitable profiting from economic opportunities in a business ecosystem where new hybrid firms such as social businesses could thrive in the presence of for-profits. Such a scenario is represented by the solid-line hill topped off with point 3, next to the long-dash-dot-line representing equal distribution of well-being. This barrenness of Pareto economics is due to the *normative indeterminateness of efficiency* (Rawls, 1999), which prevents economists from comparing the state of affairs represented by point 3 with that of points 1 and 2. The intersections of the solid-line hill with the dotted and segmented-line hills, marked with Xs, highlight the limitations of restricting the permissible methods of collective choice to certain market exchanges, because the unrealistic assumptions of Pareto optimality rules out what is actually already emerging. It also shuts the door to the study of what could be a promising new state of economic affairs marked by a hybrid firm ecosystem.

Transition to a hybrid firm ecosystem being inconceivable in mainstream economics does not necessarily mean that a radically new economic science must be built from scratch.

During the second half of the twentieth century, promising optimality rules that rival Pareto's have been developed – John Rawls's difference principle and Amartya Sen's

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if people made better off compensate the worse-off in the new state of economic affairs.

Then, Tibor Scitovsky detected a paradox in the Kaldor–Hicks criterion, consisting in the worse-off compensating the better-off in order to return to the initial situation. This paradox highlighted the need to achieve a clear aggregate benefit that overtakes the relative advantage of returning to the initial situation. In practice, because these theories are in the realm of utility metrics, or psychophysical units of welfare, they remained impractical for policy-making purposes.

capability framework, among others. However, their suitability for social businesses is not a matter we shall address here. What we do want to show is that there are more promising neoclassical contributions that lie at a less abstract level than Pareto optimality, and that they may constitute the basis for researching social businesses. Thus, we submit our second proposition:

**Proposition 2:** If Pareto optimality is related to a collective choice criterion that grants absolute priority to any one person's well-being, then social change will continue to ignore the worst-off in society and alternative forms of capitalism will remain beyond consideration.

## THE SOCIAL BUSINESS MODEL<sup>2</sup>

The conventional view holds that a for-profit enterprise operates until the difference between total revenue and total cost is maximised, that is until the marginal cost of production equals the marginal revenue, hence maximising profits. Thus, firms engage in competition, attempting to outperform one another, and resources are allocated in response to the most urgent demands able to purchase at a given price. According to an early, widely known formulation, 'It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own self-interest' (Smith, 1904, p. 16). As a result, a for-profit enterprise could be defined as a non-loss, dividend-distributing company dedicated entirely to maximising shareowners' wealth.

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<sup>2</sup> This section mainly draws from Agafonow (2013).

The evolution of the theory of the firm offers a clear-cut understanding of dividend-distributing companies based on the limiting parameters contained in the above-mentioned definition – that is, the costs, the revenues, and the motives that drive such an enterprise. Without recourse to a social welfare function assumed in a collective choice mechanism of doubtful legitimacy, namely Pareto optimality, a working definition of a dividend-distributing company finds expression in concrete phenomena present in market economies. Figure 2 puts these building blocks together into a coherent picture, with the Average Total Cost curve (ATC) located in the lower left-hand diagram as the lower limiting frontier of the operation of a firm. In other words, for a firm to be viable it must at least operate along the ATC curve, covering total costs, with the penalty of going bankrupt if it does not. Let us remember though that this is a dividend-distributing company, which means that its aim is given by the upper limiting frontier of the Marginal Cost curve (MC). That is to say, shareowners are served well whenever the firm reaches the intersection between the price given by the horizontal segmented line (or marginal revenue) and the MC curve<sup>3</sup>. Note that this coincides with the maximum possible difference between total costs and total revenues – namely profits – in the upper left-side part of Figure 2.

The million-dollar question is whether this can serve as the bedrock for researching social businesses or does it slam the door on scientific enquiry related to hybrid firm ecosystems. Let us remember that a social business is a non-loss, non-dividend company dedicated to achieving a social goal (Yunus & Weber, 2007, 2010). The interesting thing about this

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<sup>3</sup> Contrary to textbooks' conventional wisdom, the upward sloping MC curve rules out a perfectly competitive firm's everywhere-linear-homogeneous production function (Boland, 1992). Thus, Figure 2 illustrates a firm with a degree of market power made possible by quasi-rents (Townsend, 1995).

definition is that in addition to departing from a conventional for-profit firm’s definition, it adheres to the limiting parameters which characterise a market economy – namely, costs and revenues, and the motives that instead drive this kind of business: that is, it describes a compromise with the furtherance of a social mission.

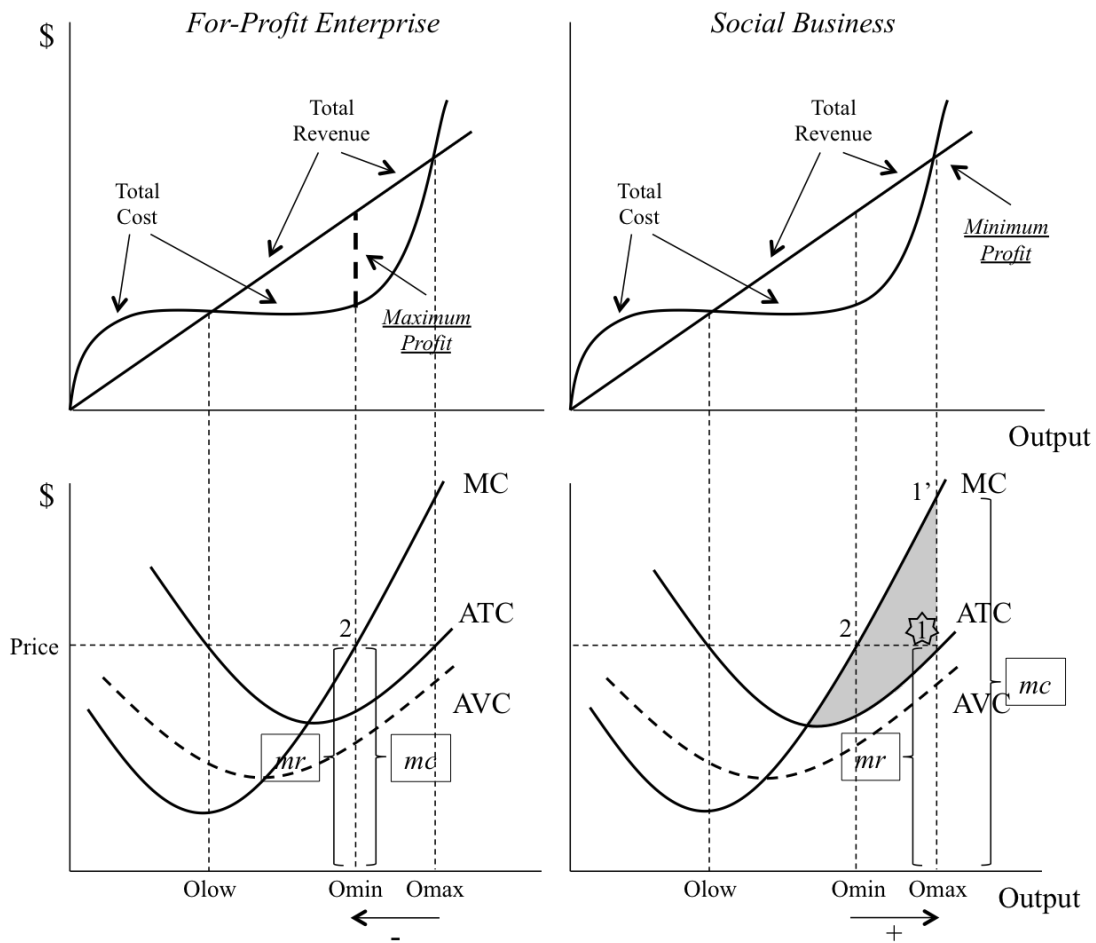


Figure 2: Cost structure of a for-profit enterprise versus a social business (Agafonow, 2013)

Because a social business is not an attempt to pull a stunt that would risk valuable capital, it takes very seriously the lower limiting frontier of the firm’s operation illustrated by the ATC curve located at the bottom right-hand side of Figure 2. That is, a social business is a non-loss company that must cover its operating costs out of a commercial activity that directly targets a vulnerable population – not just the commercial arm of a charitable organisation set

up to channel resources elsewhere. Our readers must now be wondering how this is different from a dividend-distributing company and to what extent, by charging a price to a vulnerable population, social businesses could drift away from their social mission. After all, we are talking about worst-off people who have a hard time affording things.

The answer lies in the non-dividend aspect of social businesses. If a dividend-distributing company's aim is represented by the upper limiting frontier of the MC curve – as pointed out above – we must think about how the non-dividend aspect of social businesses finds expression within the general limiting parameters given by such an enterprise's cost structure. Since profit margins – made possible by operating until the price or marginal revenue matches the MC curve, as at point 2 in the bottom right-hand side of Figure 2 – are not meant to be captured by shareowners but ploughed back into the social business, something different happens.

The right-hand side of Figure 2 illustrates these different consequences. By ploughing back profit margins a social business is able to produce as much output as  $O_{max}$  on the horizontal axis given the same price. Note that to understand this pricing strategy the relevant cost curve is the ATC curve intersected at point 1 starred, not the MC curve as in dividend-distributing companies. In fact, for the latter to be able to produce as much as social businesses, they would have to charge a price equivalent to  $1'$  in the MC curve to achieve the goal of profit maximisation. One could also say that for a social business to produce as much as a dividend-distributing company, i.e.  $O_{min}$  on the horizontal axis, it would suffice to charge a price equivalent to the intersection of the dashed vertical line arising from  $O_{min}$  and the ATC curve, instead of the higher price at point 2 that intersects the MC curve (Agafonow, 2013). Although this economic model has existed during a while, it was first

linked to a form of non-divided constraint by Enke (1945) and Newhouse (1970). Later it would become a standard proposition in the economics of non-profit organisations (see James and Rose-Ackerman 2013; Young and Steinberg 1995).

Some may rush to put forward that the social business model is sheer inefficient. Is not the MC higher than the MR after all? (Note that  $MC > MR$  in the lower part, right-hand side of Figure 2). Critics must bear in mind that efficiency is related to an ‘objective function’ which in for-profits is about appropriating dividends. The idea that MC must equal MR serves a clear goal, i.e. turning the maximum difference between costs and revenues for shareowners’ sake. If profits are going to be ploughed back into the business as in a social business,  $MC > MR$  is the only logical outcome. Moreover, if social businesses are not supposed to distribute profits, stopping where the difference between costs and revenues is at its maximum would be to hoard profits for nothing, a waste of resources. To what extent this pricing strategy runs against allocative efficiency and is still desirable under circumstances begged by the social business’s mission, is an issue open to debate.

This pricing strategy makes a social business a ‘poor friendly’ company dedicated to maximising worst-off customers’ well-being, because profit margins can be totally devoted to the enhancement of the quantity-quality mix of the company’s output (Donaldson et al., 2011). Even the most responsible dividend-distributing company will have to sacrifice some quantity and/or quality for the sake of shareowners’ wealth. But this pricing strategy applied to the production of goods or services of particular importance to the poor, makes a social business a powerful tool for the poor’s enhancement. In a sense, we could say that social businesses ‘satisfice on value capture’ (Santos, 2012), in that turning a profit margin is instrumental in allowing further investment in the quantity-quality mix rather than

maximising shareowners' wealth, but the term 'satisficing' can be misleading in this context (Agafonow, 2014a). It might be more appropriate to understand a social business as 'maximising on value devolution', which is the ability of non-dividend firms to plough profits back until the difference between costs and revenues disappears (Agafonow, 2014b), something that for-profits avoid. As a result, a final proposition follows:

**Proposition 3:** If the social business model is related to watching out for both a budget constraint and a non-divided constraint, then a social business operates effectively until the marginal revenue equals the average total cost when the output is maximised.

#### DISCUSSION AND FUTURE LINES OF ENQUIRY

Bottom-up development strategies are limited if solely based on dividend-distributing companies. High entry and exit barriers in developing economies de facto curtail the poor's freedom to choose because the resulting market structure favours local oligarchies at the expense of the population at large. If dividend-distributing companies make it into developing economies there is no reason to believe that they are not going to exploit the opportunities to turn supernormal profits enabled by market barriers that keep competitors away, unless appropriate structural reforms are undertaken to drastically reduce these barriers. Meanwhile, it seems that a different form of business is needed, a non-loss, non-dividend company or social business.

Social businesses are, however, difficult to theorise within the limits of Pareto optimality because of the so-called normative indeterminateness of efficiency. This prevents the consideration of a state of affairs that departs from the status quo in a more equitable

fashion, such as a business ecosystem in which hybrid firms like social businesses improve on the limited offerings available to the worst-off people in society. This article did not intend to outline a clear-cut alternative to Pareto optimality but rather to present some of the building blocks of the new economic rationale behind the social business model. In doing so, we have reached the conclusion that, despite their limits, there remain neoclassical contributions that offer a solid basis for researching social businesses. Thus, these can be understood and modelled as companies maximising value devolution.

The future of this research agenda is challenging because of its multifaceted and multidisciplinary nature. The body of thought of both economics and management can be revisited to see what tools and discoveries achieved in the context of pure for-profits might be adapted to serve a social business's aim and which ones might need to be created anew. Some of the critiques of social businesses sketched in the introduction are of value for understanding where future research on social business should head.

Following Garrette and Karnani (2010), for instance, a better understanding of sources of revenues and strategies to scale up will be critical for the future of social businesses. If social businesses rely only on capital self-generated out of retained surpluses that are reinvested in the company – sometimes called institutional capital – the number and size of social businesses are likely to remain small. Dees and Anderson (2003) also warn against this practice, arguing that it compromises profits. How capital accrual for social businesses can be increased without scrapping the non-dividend constraint lies at the heart of this research agenda, which parallels questions related to the current debate on for-profit versus non-profit microfinance except that here the hybrid alternative of a social business is not considered (e.g. Morduch, 1999; Bhatt & Tang, 2001; Mersland & Strøm, 2008; Roberts, 2013).



Another key aspect for the future of social businesses concerns its corporate governance, as raised by Kickul et al. (2012). Although they do not touch on the problem of ensuring that a dividend-distributing company actually maximises profits, profit maximisation cannot simply be taken for granted when there is separation of ownership and control. Ensuring that managers are controlling a company to the full satisfaction of shareowners is extremely challenging and, contrary to what Kickul et al. (2012) suggest, the participation of managers in company profits is far from being the ultimate solution (e.g. Reinhardt, 2009). Indeed, the absence of profit distribution in social businesses could be seen as a governance mechanism that insures the worst-off customers against an abusive use of market power. Thus, the point may rather be how to guarantee that a social business is maximising value devolution given possible temptations to diverge from this aim, which connects with the issue of commercial non-profits' organisational dynamics when a *non-distribution constraint* is enforced (e.g. Steinberg & Gray, 1993; Hansmann, 2003; Ortmann & Schlesinger, 2003).

Last but not least, despite the need to dispense with Pareto optimality in order to advance a research agenda related to hybrid firm ecosystems, it is necessary to research possible new equilibria arising out of social businesses departing from the maximisation of value capture on a financially sustainable basis. What is the likely impact on income distribution of a growing number of social businesses competing with dividend-distributing companies in a hybrid firm ecosystem? How can social businesses contribute to fostering inclusive economic growth? Is there any future for social businesses in high-income economies or are they limited to low-income developing economies? (Let us remember that the EU's Social Business Initiative is promoting the creation of social businesses in Europe.) What are the

implications for innovation and technological progress in a hybrid firm ecosystem? Is the development of a capital market that targets social businesses possible?

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