

The Efficacy of the Social Enterprise Model

By

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Research Report² as part of Master of Liberal Studies
Georgetown University

A growing number of nonprofit organizations have launched commercial businesses to provide work experience and job training opportunities for disadvantaged individuals. Commonly referred to as social enterprises, these businesses use revenue generated from products and/or services that their client workforce helps produce to pay for wages and other forms of assistance. Social enterprises range from manufacturing plants to bakeries, restaurants, grounds maintenance, and translation services. They typically fall under four categories:

1. Traditional sheltered workshops that receive preferential treatment for government funds
2. Open-market businesses that compete with the private-sector without government assistance
3. Individual franchises within a national corporation
4. Enterprises that grow out of a nonprofit organization's social service programs

The social enterprise model raises four important issues and several related questions that could undercut the viability of employing and training disadvantaged individuals:

1. **Private-Sector Competition:** Do social enterprises, subsidized in part by charitable giving and/or taxpayer dollars, have an unfair advantage over private-sector businesses that sell similar products or services? Are social enterprises more efficient at providing services than the private sector? Should social enterprises pay taxes on their profits just like traditional earned income ventures do?
2. **Sustainable:** Can social enterprises be profitable or do they typically cost more to run than the revenue they generate? Can nonprofit organizations sustain and expand these ventures or are most doomed to fail?
3. **Mission-Drift:** Do nonprofit organizations run the risk of straying from their original mission by focusing too much attention on operating social enterprises to generate revenue?
4. **Effectiveness:** Is social enterprise an effective method for improving the employment outcomes of disadvantaged individuals?

To test the strength of these concerns, this brief presents scholarly arguments from proponents and skeptics of the social enterprise model, as well as findings from five case studies:

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² The full report is available at: www.transitionaljobs.net/Resources/MakingSocialEnterprisesWorkForWelfare.pdf

- **Pioneer Human Services:** a Washington-based enterprise that permanently hires ex-offenders to work at a aircraft parts manufacturing plant (contracting with Boeing Company), as well as several other assembly, packaging and warehousing plants.
- **Sweet Beginnings:** a Chicago-based enterprise that provides temporary job opportunities in honey cultivation and production for ex-offenders who graduate from a related job readiness program.
- **The Enterprising Kitchen:** a Chicago-based enterprise that employs disadvantaged women on a temporary basis to produce and sell natural soap products.
- **Juma Ventures:** a San Francisco-based enterprise that has operated a franchise of Ben & Jerry's, as well as ice cream and coffee concessions at sport venues, to provide temporary jobs for disadvantaged youth.
- **Work Options for Women:** A Denver-based enterprise that operates the county government cafeteria to provide culinary jobs for welfare recipients and other low-income women.

Private-Sector Competition

Question: *Do social enterprises have an unfair tax advantage over private-sector businesses?*

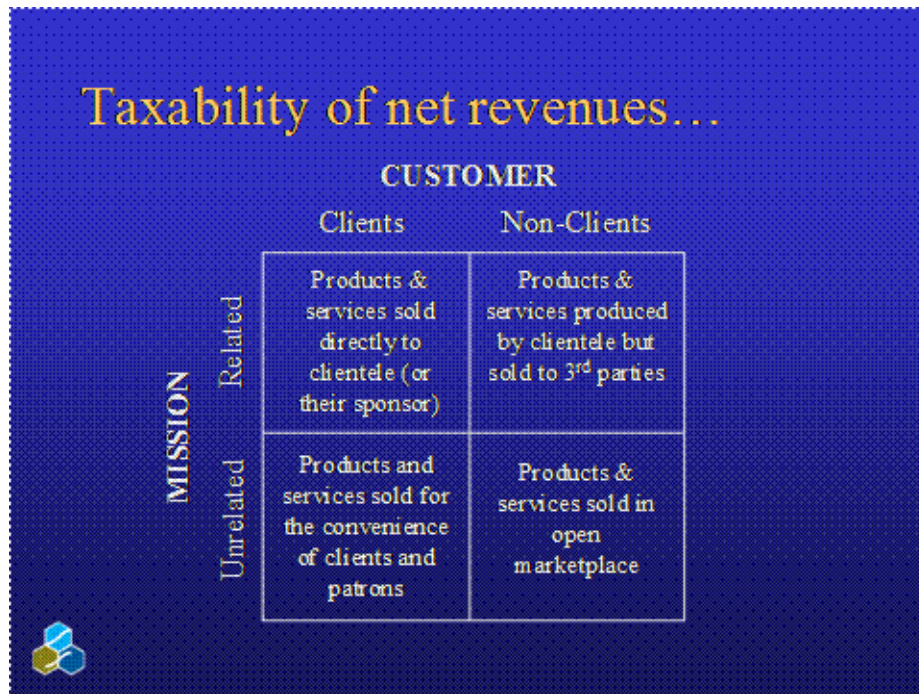
Answer: *Social enterprises can be held to a tax—Unrelated Business Income Tax—if it generates considerable profit unrelated to its mission. Nonetheless, critics claim that the ease of avoiding UBIT still provides social enterprises an unfair competitive advantage. Supporters assert that the favorable tax status helps to balance out the inherent disadvantages that social enterprises face in competing with the private sector, including social mission costs, size inefficiencies, difficulty attracting people with valuable business skills, and limited access to capital.*

Full Explanation: No quantifiable evidence could be found to support the assumption that private businesses have suffered financial loss on account of competition by social enterprises offering similar products and services. Nonetheless, it stands to reason that some social enterprises may take away business from private-sector firms. When Goodwill wins a contract to mow lawns, assemble goods, or clean office buildings, private firms lose a chance to expand their customer and revenue base. Drawing an example from the wider array of earned income strategies, the YMCA has been criticized by some private-sector fitness centers (Weisbrod 2004).

Ultimately, the debate comes down to the fairness of the tax system. The government exempts nonprofit organizations from having to pay taxes in an effort to lower the burdens and increase the incentives of providing charity. The trend toward earned-income practices, including social enterprise businesses, raises the question of whether nonprofit organizations should pay taxes on revenue.

Goodwill Industries, the Girl Scouts, and other large operations generate millions each year through product sales, but their nonprofit tax status is not in jeopardy because the Internal Revenue Service (IRS) considers these earned income activities to be integrally linked to their social missions. The IRS looks at whether organizations earn “substantial” revenue from earned-

income activities that are deemed unrelated to their mission and occur on a “regular” and “ongoing” basis. If these standards are met, nonprofit organizations are forced to pay what is known as the Unrelated Business Income Tax (UBIT). (Bromberger 2006) (McClurg 2006). The figure below helps decipher whether business income is considered related or unrelated to a nonprofit’s mission, and thus subject to federal tax (McClurg 2006).



Business products and services that are unrelated to the nonprofit’s mission and are targeted primarily to customers who are not clients, as depicted in the lower-right quadrant, are likely to be taxed. If such income represents a significant portion of the nonprofit’s total income, typically more than 20 to 30 percent, the nonprofit’s tax exempt status may be in jeopardy. In contrast, social enterprises typically fit in the upper-right quadrant. For instance, The Enterprising Kitchen sells products to “non-clients” but those products are created in the course of fulfilling its charitable mission of providing paid work experience to disadvantaged women. Thus, The Enterprising Kitchen’s tax status is not in jeopardy (McClurg 2006).

The common complaint is that tax exemptions and ease of avoiding UBIT give nonprofits engaged in business activities an unfair competitive advantage. Social enterprise supporters assert, however, that this concern is exaggerated. They claim that nonprofit organizations in fact have “inherent disadvantages with regard to social mission costs, size inefficiencies, difficulty attracting people with valuable business skills, and limited access to capital” (Dees and Anderson 2003, 27).

Efficiency

Question: *Are social enterprises better, and more efficient, at providing social services than the private sector?*

Answer: *Critics claim that nonprofits have little incentive to cut costs—and watch their bottom line—because of government subsidies and preferential treatment in tax system. Moreover, critics claim that nonprofits lack accountability because their donors are rarely in a strong position to evaluate their efficiency and effectiveness. In contrast, for-profit firms are dependent on customers voluntarily choosing to pay for their products; therefore, they have to find a cost-effective way to deliver goods and services. Supporters note that government has traditionally directed public dollars to nonprofit organizations to deliver essential services because they are not motivated by profit, and, thus have no reason to cut corners. Furthermore, social enterprise operations may be in better position to provide services more efficiently and effectively than private businesses and traditional nonprofit organizations because they are concerned with not one but two bottom lines: (1) to ensure their operations are economically sustainable and (2) to make a social impact.*

Full Explanation: Scholars debate whether nonprofit organizations provide services more or less efficiently than the private sector. This debate has taken on greater significance as more for-profit firms have begun competing for government contracts to deliver social services, such as welfare-to-work activities. The very presence of for-profit firms in these endeavors indicates that these services could be provided without government subsidy or preferential treatment in the tax system. Free-market advocates take the argument one step further, suggesting that private businesses can provide these services more efficiently because nonprofits, backed by government subsidies, have less incentive to cut costs and watch their bottom line (Bennett and DiLorenzo 1989).

Government has traditionally directed public dollars to nonprofit organizations to ensure the delivery of essential services that, because of thin markets, poor consumer information, or public goods problems, would otherwise be provided poorly or not provided at all. Nonprofits are considered to be in a good position to deliver those essential services by virtue that they are not motivated by profit and, thus, have no reason to cut corners to save funds (Lee 1989). In fact, it has been argued that people are more likely to trust nonprofits because of the “nondistribution” constraint: nonprofits cannot pay out profits to those in a controlling position (Dees and Anderson 2003).

Scholars have pointed out that the inability to disburse profits does not guarantee against corruption and does not ensure effective performance, as noted below.

Because of the non-distribution constraint, complacency, inefficiency, and waste can be serious problems in nonprofit organizations. ... A nonprofit can survive, even thrive, and yet be very inefficient and ineffective in creating social value and serving its mission. (Dees and Anderson 2003, 26)

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The increasing trend toward earned-income strategies could be a catalyst for increasing efficiency in the nonprofit sector. Social enterprise operations, unlike private businesses and traditional nonprofit organizations, are concerned with not one but *two* bottom lines: (1) to ensure their operations are economically sustainable and (2) to make a social impact (Alter 2006). The argument is that possessing a social mission, on top of the new-found fiscal conservatism, puts social enterprises in a better position than private-sector businesses to deliver social services (Anderson 2005).

Sustainability

Question: *Can social enterprise ventures generate profits or are they a drain on overall resources of the organization?*

Answer: *On the optimistic side, as many as two-thirds of ventures are either profitable or at least break even; on the pessimistic side, the proportion is less than one-third. Skeptics point out that social enterprises are more likely to fail than private-sector businesses for four reasons: 1) cost-cutting strategies might conflict with its ideals of offering livable wages; 2) failure to account for all business expenses, including worker downtime, product development, infrastructure, and staff salaries; 3) difficulty in finding customers and markets; and 4) unwillingness to terminate unprofitable ventures if tied to their mission. In addition, social enterprises may be difficult to sustain, given the low skill levels and low productivity associated with their targeted workforce. In a mainstream business, workers who underperform or have significant problems would be fired. Social enterprises attempt to minimize this risk by ensuring their workers have access to a variety of support programs.*

Full Explanation: The spectacle of nonprofit organizations seeking business income raises questions over whether these ventures are profitable or a drain on overall resources. One reason nonprofit organizations have undertaken earned income strategies is to provide new sources of funding for its programming. Otherwise, the organization may not be able to sustain their mission to employ and train disadvantaged individuals.

Social enterprise ventures tend to operate small retail businesses, such as ice cream shops, thrift stores, restaurants, and cafés, which are unlikely to succeed on a double-bottom-line basis. Small retail businesses produce very low profit margins, which are insufficient to cover the additional costs of social mission activities. Often generating as little as \$200,000 in annual revenue, small social enterprises cannot create a meaningful number of job opportunities and cover the incremental training, management, and other costs associated with employing an unskilled and disadvantaged workforce.

With little ability to grow business revenues, these social enterprises cannot reach a level of scale that provides sufficient revenue to cover these additional “social costs.” It is estimated that social enterprises need to generate about \$1 million annually to create a significant number of jobs and to operate in a financially sustainable manner. However, few retail businesses are likely to approach this level of sales (Schorr 2006).

Researchers disagree about the proportion of social enterprises that are profitable. On the optimistic side, two recent surveys reported that a half to two-thirds of ventures were either profitable or at least breaking even (Massarsky and Beinhacker 2000) (Community Wealth Ventures 2003). The validity of those findings was questioned by another research team.³ That team conducted a different survey, which found that 71 percent of ventures were not profitable, while only 24 percent reported profits, and 5 percent broke even. Moreover, the latter survey reported that half of those recording profits did not fully account for indirect costs, such as allocations of general overhead, senior management time, and start-up costs (Foster and Bradach 2005).

Researchers who are skeptical of the sustainability of social enterprises point out that most private-sector businesses fail within five years. They contend that the prospects for nonprofit ventures are likely even grimmer for four main reasons (Foster and Bradach 2005):

1. Nonprofits' desire to make money might conflict with its ideals of offering livable wages and selling products at prices that disadvantaged individuals can afford. As a result, nonprofits may not build the kind of highly competitive, profit-focused culture that is essential to the success of many commercial enterprises.
2. Nonprofits may not recognize the full expense of running a business, by failing to take into account the cost of worker downtime, product development, infrastructure, and staff salaries.
3. Nonprofits may struggle to find customers/markets for their products.
4. Nonprofits may be unwilling to pull the plug on unprofitable ventures because of their commitment to fulfill their social mission. In addition, philanthropic funding may absorb some of the losses.

Most social purpose businesses lose money and require ongoing funding subsidies to support their operations. However, these subsidies are not readily available because philanthropic foundations typically reserve their support to covering start-up costs. These grants dry up over time, leaving unprofitable social enterprises with mounting levels of debt. (Schorr 2006)

In terms of the case studies, Sweet Beginnings has had difficulty sustaining and expanding its operations. After three years in operation, the enterprise generated modest product revenue, limiting its ability to hire more ex-offenders and, thus, have a larger impact in the community. North Lawndale Employment Network, the parent organization of Sweet Beginnings, also incurred a sizeable debt in launching the enterprise (Wallace 2007).

The organizations enlisted the help of Boeing and Ben & Jerry's to chart a more sustainable business plan. Sweet Beginnings has become a separate legal entity to eliminate the financial risk to NLEN. Under the new strategic plan, Sweet Beginnings hopes to grow to 100 employees in 10 years, at an expected cost of \$500,000, by selling honey products at popular tourist attractions in Chicago, Hyatt hotels, and as part of toiletry bags given to offenders leaving the state's prison system. The Corrections Department recently awarded the charity a grant worth \$300,000. The

³ They contended that the survey results were skewed by the fact that profitable ventures were more likely to respond to the survey and undercount their operating expenses, including hefty start-up costs (Foster and Bradach 2005).

MacArthur Foundation gave NLEN a \$400,000 grant to pay off debt and establish a cash reserve (Wallace 2007).

Furthermore, social enterprises may be difficult to sustain, given the low skill levels and low productivity associated with their targeted workforce. In a mainstream business, workers who underperform or have significant problems would be fired, but a central element of social enterprises is to employ such individuals.

Social enterprises attempt to minimize this risk by ensuring their workers have access to a variety of support programs, such as mental health counseling, subsidized housing, or other services, which may be necessary for them to achieve greater personal success (Dees, Emerson, and Economy 2001).

Juma Ventures nearly was forced out of the concessionaire business its first year due to the poor on-the-job performance of its youth vendors (Maran 2003). Only four of the first 17 youth assigned to concessions completed the baseball season. The 12 employees who were unsuccessful were either fired due to problems with theft, tardiness, or a lack of improvement in job performance, or they simply disappeared from their jobs. The low employment outcomes were attributed to poor training and planning (Emerson and Twersky 1996).

Juma responded to its earlier employment difficulties by making some difficult trade-offs. With respect to hiring, Juma has sought to develop a manageable mix of youth employees at various skill and functioning levels. Juma has contended that only hiring high-risk youth would require a greater investment of training resources and, thus, would make it more difficult to reach profitability goals. By also hiring more advantaged workers, Juma has created structures that enable the organization to accommodate greater training needs while maintaining profitable performance (Emerson and Twersky 1996).

Mission Drift

Question: *Do nonprofit organizations run the risk of straying from their original mission by focusing too much attention on generating revenue?*

Answer: *To avoid mission drift, social enterprises must make a difficult trade-offs between the quality of care provided, the number of people served, and the profitability of the venture. Nonprofit managers who turn their full attention to determining how and where to sell their product may end up neglecting their responsibilities in monitoring the quality of services provided to its clientele, such as education and training. Additionally, nonprofit managers must contend with the potential high cost of employing individuals with the severest barriers to employment.*

Full Explanation: A social enterprise that does not break even may still be a worthy investment if it furthers the nonprofit's mission (Foster and Bradach 2005). The danger with earned income strategies is that a nonprofit may become so preoccupied with how to generate a profit that its staff neglects the social mission altogether. Alternatively, the nonprofit may refocus its mission to align with more profitable and effective business strategies. In either case, the nonprofit has experienced what is known as "mission drift" (Dees, Emerson, and Economy 2002).

Launching and running a venture may consume scarce management resources, diluting an organization's focus on social programs. For instance, nonprofit managers, in turning their full attention to determining how and where to sell their product, may neglect their responsibilities in monitoring the quality of services provided to its clientele, such as education and training (Foster and Bradach 2005).

Moreover, nonprofit managers may find it too difficult and costly to employ individuals with the severest barriers to employment (Dees and Anderson 2003). They may decide instead to expand the eligibility of job slots in order to hire higher-skilled workers who can raise productivity and efficiency of the operations, which Juma decided to do to a certain degree. In this respect, the organization has neglected its mission of employing and training the hardest-to-serve, in order to improve its bottom line (Foster and Bradach 2005).

The situation is made worse by the lack of clear performance measures in the nonprofit sector. It is difficult for customers, payers, and donors, and even board members and managers, to recognize when certain activities are actually causing a decline in social impact (Dees and Anderson 2003).

A related concern is that the presence of a profit motive and emphasis on efficiency might lead social enterprises to cut corners, lowering both costs and the quality of social services. This raises the question, "Is it better to maintain very high quality and stay small, or would it be more socially desirable to lower quality but expand capacity to serve more of the people in need?" (Dees and Anderson 2003, 21). Service providers must make a difficult trade-off between the quality of care provided and the number of people served (Dees and Anderson 2003).

Effectiveness

Question: *Is social enterprise an effective model for improving the employment outcomes of disadvantaged individuals?*

Answer: *Studies have shown that social enterprises, provided with proper financial and technical assistance, can achieve impressive employment rates for its client workforce. Case studies had varying levels of effectiveness at placing their workforce in permanent jobs. In the meantime, there is a growing interest to measure a broader array of indicators that comprise a social return on investment: calculating projected business performance, such as income generated by business sales; projected social benefits, such as number of jobs created for a target population, their expected wage rate, and taxes owed as a result of the employment; and projected social welfare savings, such as reduced public expenditures on welfare and other social services.*

Full Explanation: Even if a social enterprise competes fairly in the market and generates enough revenue to be sustainable without diluting its mission, it cannot be considered effective unless it has achieved success helping clients overcome their personal problems, such as unemployment, poverty, or homelessness.

The Enterprising Kitchen reported that 70 percent of clients found unsubsidized jobs or enrolled in education within a year of completing the program. Juma Ventures reported that three-quarters of youth participants were still employed 28 months after enrolling in the program and experienced steadily increasing incomes. Additionally, Work Options for Women reported that 85 percent of program graduates were still employed one year after their job placement. These employment rates, 70 percent, 75 percent, and 85 percent, respectively, are considerably higher than the national average for job training programs, which stands at 54 percent.

The Roberts Enterprise Development Fund (REDF) has studied the employment outcomes of nearly 1,000 individuals who have been employed in one of 19 social enterprises. The study has found that 75 percent of participants retained their jobs over a two-year period, with many transitioning into unsubsidized employment. In addition, their monthly income has tripled, their educational levels have improved, housing has stabilized, and criminal recidivism rates have declined dramatically (Schorr 2006).

There is a trend in the social enterprise field of defining impact more broadly to include positive outcomes for clients, the enterprise, and society as a whole. This concept is known as *social* return on investment (SROI). In the traditional sense of return on investment, investors expect to earn dividends on the stocks they have purchased. In contrast, in SROI, social enterprise donors measure performance of their investment in terms of whether a social impact was made.

There are no generally accepted methods or metrics for assessing SROI. However, a leading model has been developed by REDF. The foundation determines a social enterprise's SROI by calculating projected business performance, such as income generated by business sales; projected social benefits, such as number of jobs created for a target population, their expected wage rate, and taxes owed as a result of the employment; and projected social welfare savings, such as reduced public expenditures on welfare and other social services (Streeter 2001).

For instance, in its assessment of the social enterprise Recycled Merchandise, REDF calculated a per-dollar enterprise and social purpose "indices of return" of 14.48 and 24.97, respectively. This means that for every dollar invested in the social purpose enterprise, Recycled Merchandise generated \$14 in revenue and nearly \$25 dollars in social savings to taxpayers and increased disposable income to clients (Streeter 2001).

In order to track SROI, REDF has made a sizeable investment in information technology. It has developed a management information system (MIS) to track social impact data and income data from each of the social enterprises it funds. The MIS tracks target employees' use of various social services when first hired and tracks changes in the use of services at six-month intervals over the following two years (Streeter 2001).

The impact of some social enterprises can be estimated more generally. For instance, YouthBuild spends an average of \$20,000 to provide education, support services, and employment opportunities in construction trades for high-risk youth. The youth participants typically had dropped out of high school and encountered the juvenile justice system. Predictable outcomes for this population are a life of unemployment and periodic incarceration. The typical prison cost of one inmate per year can range from \$25,000 to \$40,000, depending on the type of detention

facility and location, not to mention the loss of productivity and taxable income. Therefore, the large up-front investment YouthBuild makes in its clients can be deemed worthwhile (Dees 1998).

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