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Value Devolution in Social Enterprises: Institutional Economics and Systems Theory Perspectives

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Abstract

Agafonow's article locates the role of social enterprises in devolving value through output maximizing behavior. This short paper embeds Agafonow's argument in the societal and institutional context by building upon Luhmann's social systems theory. According to Luhmann, the functional system of the economy exhibits "imperatives" that cause social ills. The institutional form of social enterprises is shown to weaken these imperatives in several ways. One of these ways, discussed by Agafonow, is the substitution of profit maximization by output maximization. Other ways are the substitution of high-powered incentives by low-powered ones as elaborated in the work of Williamson and Hansmann.

Keywords

value devolution, social enterprises, Niklas Luhmann, Oliver Williamson, Henry Hansmann

Introduction

Alejandro Agafonow's (2014) article breaks new ground in the economic understanding of social enterprises. He correctly attests to the literature on

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social enterprises a state of conceptual confusion over their economic logic. Should social enterprises maximize profit or rather avoid profit maximization? Should they capture value like for-profits or rather behave like philanthropically oriented nonprofits? Agafonow convincingly resolves this schizophrenic impasse with a novel idea of value devolution. The idea means that social enterprises create value, but instead of capturing it, utilize it for the benefit of a wider vulnerable clientele. Technically, according to the author, social enterprises output maximize, that is, price their output lower than for-profits would do, thus making it accessible to poorer customers. This argument is as simple as it is powerful, and is bound to stimulate a lively debate in the subsequent scholarship.

One dimension of this debate will be likely related to the broader theoretical embedding of the idea of value devolution. By linking value devolution to the output maximization rule, Agafonow embeds it in the neoclassical economics. This is a highly original position, for it is rather uncommon for the mainstream school of economic thought to be invoked in connection with the justification of nontraditional business models. Yet, the originality notwithstanding, the argument is affected by the very same problems that are commonly associated with the neoclassical economics itself. These are, most importantly, the lacking consideration of society as a real-world going concern, and disinterest in institutions (cf. Hodgson, 2013; Valentinov, 2014b). These are the two aspects that the present comment will address. It will connect the idea of value devolution to the societal context by drawing upon Niklas Luhmann's work on social systems and functional differentiation. It will likewise highlight the affinity of value devolution to the role of the nonmarket institutional arrangements in the Nobel Prize-winning transaction cost theory of Oliver Williamson as well as in the seminal work of Henry Hansmann.

Luhmann on Social Systems

Niklas Luhmann, an outstanding German sociologist of the 20th century, developed a grand sociological theory around the pivotal idea of the precarious relations between social systems and their environment, societal and natural alike. To Luhmann, the precariousness of the system–environment relations is hardwired into the basic systemic function of complexity reduction aimed at the relieving of individuals from the need to process enormous amounts of information. Social systems reduce complexity by allowing individuals to disregard the greater part of this information. Unsurprisingly, this disregard has an important by-product of undermining the sustainability of the concerned systems as well as of the modern society as a whole. Valentinov

(2014a, p. 14) summarized the sustainability implications of Luhmann's social systems theory in the model of the complexity-sustainability trade-off, which posits that the complexity reduction function of social systems causes them to develop insensitivity to those environmental conditions on which they critically depend, thereby worsening their own survival prospects (cf. Valentinov, 2013a, 2013b).

The destructive potential of the complexity-sustainability trade-off is at its peak in the regime of functional differentiation which, to Luhmann, is a defining attribute of modernity. In contrast to the earlier segmentary and stratificatory types of social differentiation, functional differentiation denotes the decomposition of society into the functional systems, such as economy, politics, law, science, education, and religion. Functional systems, according to Luhmann, exhibit idiosyncratic dynamics, or systemic imperatives, which are prone to render them particularly insensitive to their environment. The prominence of systemic imperatives underpins the divergence between what Luhmann (1989) called "system rationality" and "world rationality":

> to the extent that system rationality appears more realizable it becomes less world-rational and even less socially rational . . . once this becomes clear one can also see that this is not a matter of an "iron law" but rather of the costs of increasingly improbable complexity. (p. 138)

As a result, "a functionally differentiated world system seems to undermine its own prerequisites" (Luhmann, 1990, p. 183).

A dramatic illustration of the complexity-sustainability trade-off in action is the degradation of the natural environment as a result of the successful realization of the complexity reduction function by the functional system of the economy (cf. Valentinov, 2014b). As a functional system, the economy is

> a rigorously closed, circular, self-referentially constituted system because it effects payments that presuppose the capacity for making payments . . . Thus money is a unique economic medium. It cannot be introduced as input from nor transmitted as output into the environment. Its exclusive task is to mediate system-internal operations. (Luhmann, 1989, p. 52)

The above-mentioned attributes of closure, circularity, and self-referentiality make the economic system happily unconcerned with the state of its natural environment:

> The key to the ecological problems, as far as the economy is concerned, resides in the language of prices. This language filters in advance everything that occurs in the economy when prices change or do not change. The economy

> cannot react to disturbances that are not expressed in this language. (Luhmann, 1989, p. 62)

Of particular relevance to the role of social enterprises is the fact that the tendency of the economic system to undermine its own sustainability pertains not only to the natural environment, but also to the societal one (cf. Valentinov, 2015a; Valentinov and Chatalova, 2014). A moment's reflection shows that the missions of social enterprises address those societal problems that arise as a result of this tendency. Agafonow makes clear that the primary beneficiaries of value devolution are the disadvantaged and vulnerable people. Hence, an implication of the idea of value devolution is that the economic system generates social disadvantage and vulnerability, which present, in terms of Luhmann's social systems theory, unfortunate manifestations of the precariousness of the relations of the economic system with its societal environment. The value of the Luhmannian perspective is in locating these social ills at the interface of the system–environment relations instead of straightjacketing them into the intra-systemic and orthodox concept of market failures.

How do social enterprises actually manage to devolve value? Agafonow's neoclassical answer to this question is in terms of the behavioral pattern of output maximization. The Luhmannian perspective informs this answer by linking it to the logic of functional differentiation, which has been shown above to suffer from the divergence between the "world rationality" and "system rationality." Given that this divergence is driven by systemic imperatives, and more specifically by the systemic imperatives of the economy, it is reasonable to conjecture that the societal sustainability of the economy can be improved through the weakening of these imperatives. The operational meaning of this weakening is well illustrated by Agafonow's vision of the substitution of the profit-maximizing behavior of for-profit firms by the output maximizing behavior of social enterprises. Obviously, this substitution involves a weakening of the systemic imperative of profit orientation. Another systemic imperative of the economy that is being weakened through the institutional form of social enterprises is the control by owners and managers. Thus the governance of social enterprises can be reasonably expected to be more democratic and participatory than is the case in the for-profit sector (cf. Borzaga and Galera, 2012).

Value Devolution and Institutional Economics

The weakening of the systemic imperatives, which is implied in Agafonow's treatment of output maximizing behavior, has likewise important parallels in those strands of institutional economics that deal with the nonmarket governance arrangements. The authoritative reference here is Oliver Williamson's (2010) transaction cost economics, which has been insightfully discovering the efficiency rationales behind hierarchies, hybrids, and other contractual arrangements that are clearly different from the "arms-length" market contracting. The award of the Nobel Prize to Williamson signals a clear acknowledgment that even though these nonmarket institutional arrangements "work out of low-powered incentives, and are beset by . . . bureaucratic distortions" (Williamson, 1996, p. 151), they nevertheless remain valuable and inherent institutions of capitalism. It is evident that the high-powered incentives characteristic of the "arms-length" market contracting reflect and embody the systemic imperatives of the economy as a functional system in the Luhmannian understanding. The recourse to low-powered incentives analyzed by Williamson accordingly indicates the weakening of these imperatives. Williamson saw the effect of this weakening primarily in the economizing on transaction costs in situations of high asset specificity. The Luhmannian perspective, however, suggests that this effect can be seen much more generally and indeed can be used to justify the whole spectrum of social enterprises and organizations of the nonprofit sector (cf. Valentinov, Hielscher & Pies, 2015; Valentinov, 2015b).

For example, in a classic article exploring the economic role of nonprofit organizations, Henry Hansmann (1980) argued that for-profit entrepreneurs operating in specific high-transaction cost environments will be led to take opportunistic advantage of the insufficiently informed consumers. According to Hansmann, the nonprofit organizational form presents a solution to this problem by the simple means of lowering the intensity of incentives of such entrepreneurs:

> The nonprofit producer, like its for-profit counterpart, has the capacity to raise prices and cut quality . . . without much fear of customer reprisal; however, it lacks the incentive to do so because those in charge are barred from taking home any resulting profits. (p. 844)

Again, similar to Williamson, Hansmann (1980) acknowledged the undesirable side-effects of low-powered incentives:

> One would expect that when the profit motive is eliminated a price is paid in terms of incentives . . . [N]onprofit firms might be expected to be slower in meeting increased demand and to be less efficient in their use of inputs than for-profit firms. (p. 844)

Thus, the Luhmannian perspective not only brings to light the common systems-theoretic logic of the institutional economics standpoints of Hansmann and Williamson, it also shows Agafonow's value devolution idea to be a variation on the same systems-theoretic theme of partially sacrificing the systemic imperatives for the sake of improving the sustainability of the respective social system in the respective environment. More than that, the Luhmannian perspective enriches the standpoints of Williamson and Hansmann by pointing out that the replacement of high-powered incentives by low-powered ones is not an end in itself, but rather an instrument of making the functional system of the economy more sensitive to the needs of its societal environment. Agafonow comes very close to recognizing this point by connecting value devolution to the needs of those consumers that stand out in terms of their disadvantage and vulnerability.

Concluding Remarks

Summing up, Agafonow has convincingly shown that the output maximizing behavior of social enterprises enables them to advance economic inclusion by means of devolving value. For-profit firms are keen on capturing value rather than on devolving it. However, Agafonow's refreshing terminology of value capture and value devolution curiously suggests a subtle complementary relationship between the worlds of for-profit firms and social enterprises. In a global sense, one can argue that before value can be devolved, it needs to be created, and its creation would not have been possible without the incentives of capturing it. This global sense refers to the civilizational value of technology. It was Joseph Schumpeter who famously traced technological innovations back to the incentives of value capture. Almost a century later, Mohammad Yunus (2010, p. 58) pointed out that once technology comes into existence, it can be used not only by profit-seeking capitalists but also by social enterprises whose economic logic, however, is still far from being well understood. By elaborating on value devolution through output maximization, Agafonow made a valuable contribution to this understanding. As the present comment explains, value devolution through output maximization is part of the larger picture of the weakening of the systemic imperatives of the economy for the sake of improving its sensitivity to the societal environment.

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