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Caritas in Veritate, Hybrid Firms, and Institutional Arrangements

Michael Troilo
Assistant Professor of International Business
Collins College of Business
The University of Tulsa

Pope Benedict XVI's recent encyclical, *Caritas in Veritate*, calls for businesses to play a role in authentic human development. One of the pope's ideas is for firms to pursue both profits and the common good with equal fervor. This article categorizes possible types of such hybrid firms and explores the institutions necessary for promoting them. It suggests that a robust civic space, careful attention to tax policy, and an emphasis in business education on social entrepreneurship would promote the formation and growth of hybrid firms. Further work is necessary to quantify the optimal distribution of profits of these firms among their respective stakeholders.

Introduction

In his encyclical *Caritas in Veritate* (Charity in Truth), Pope Benedict XVI calls the world to pursue authentic human development. This development, fostered by God and the recognition that every person and all people are created in God's image and likeness, is a holistic approach embracing the economic, political, social, technological, and spiritual realms of human endeavor. In particular, Pope Benedict XVI addresses the state of the global economy and the myriad ways in which it is and is not furthering the objective of authentic human development.[1] He devotes an entire chapter out of the six chapters of his missive to the theme of economic development.

Chapter 3 specifies the ways in which charity in truth should suffuse economics and commerce. Pope Benedict XVI advocates "a market that permits the free operation, in conditions of equal opportunity, of enterprises in pursuit of different institutional ends. Alongside profit-oriented private enterprise and the various types of public enterprise, there must be room for commercial entities based on mutualist principles and pursuing social ends to take root and grow. It is from their reciprocal encounter in the marketplace that one may expect hybrid forms of commercial behavior to emerge, and hence an attentiveness to ways of *civilizing the economy*."[2]

This article examines the formation of hybrid enterprises and the institutional arrangements that might promote them.[3] It seeks to distinguish hybrid firms from other organizations that further the common good, such as nonprofit organizations (NPOs) and nongovernment organizations (NGOs) (see Table 1 below). Because the type of enterprise that Pope Benedict XVI proposes is scarcely studied relative to the amount of scholarly research devoted to both for-profit firms and to nonprofit organizations, this article is hardly the final word on the subject. In practice, hybrid firms have been in existence for some time, but they have not received sufficient attention in academic literature, specifically in management and economics. This manuscript proposes to classify and categorize hybrid firms, to explore institutions conducive to establishing and promoting them, and, thereby, to expand the discussion on this important topic in economic (and human) development. To use the words of Robert G. Kennedy, this article is "aspirational, not descriptive, in an effort to offer a vision of what businesses could and should be in a society if they were to fulfill their potential to contribute to human well-being."[4]

Table 1: Organizations Furthering the Common Good

Type	**Welfare Motive?**	**Profit Motive?**	**Primary Revenue Source**
Government agency	Yes	No	Taxes
NGO	Yes	No	Donations
NPO*	Yes	No	Donations
Hybrid enterprise	Yes	Yes	Sales of goods and services
Socially responsible firms	Yes, but secondary to earning profits	Yes	Sales of goods and services

*Has legal standing as a tax-exempt organization

Rerum Novarum, Populorum Progressio, and Human Development

The seminal encyclical of Catholic social teaching is Pope Leo XIII's *Rerum Novarum* (Of New Things). It is subtitled "Rights and Duties of Capital and Labor," and through it Pope Leo XIII takes issue with both Marxism and unbridled capitalism. He affirms the ownership of private property, condemns class warfare, and asserts that the state must not absorb the family or the individual. He also proposes the concept of a just wage and argues for the rights of workers, including the right to organize in unions and, in extreme cases, to strike.[5] He reminds the rich that they must not abuse the poor, as the Lord hears the cry of the defrauded laborer (James 5:4).

Pope Paul VI directly builds on *Rerum Novarum*, as well as other pertinent encyclicals such as *Quadragesimo Anno* and *Gaudium et Spes*, when he advances his central theme of authentic human development in his *Populorum Progressio* (The Development of Peoples). For human development to be authentic, it must apply to every person and to all people, and it must be ordered toward God.[6] Economic development is certainly part of human development, but it must be pursued alongside and subordinate to spiritual development. The ultimate goal is a "transcendent humanism," where "man's life is united with the life-giving Christ."[7]

Caritas in Veritate updates *Populorum Progressio* for the twenty-first century. While acknowledging that his predecessor's encyclical contains timeless wisdom based on its roots in apostolic tradition,[8] Pope Benedict XVI also states his intention to revisit Pope Paul VI's teachings in order to apply them to present conditions.[9] This is pertinent given the current global economic crisis and a degree of interdependence among nations unimaginable in 1967 when Pope Paul VI penned his missive. Like his predecessor, Pope Benedict XVI maintains that authentic human development incorporates yet supersedes economic development; indeed, he spends a full chapter recapitulating the message of *Populorum Progressio*. Authentic human development has charity at its core and is situated in the gospel and person of Jesus Christ.[10]

Reflecting on the current economic state of affairs, Pope Benedict XVI notes that "*human costs always involve economic costs*, and economic dysfunctions always involve human costs."[11] He calls for a revaluation of the global economy and its goals and commences to articulate how economic activity can be made consonant with both justice and the common good. One idea is to create space in the market for actors who "operate according to principles other than those of pure profit, without sacrificing the production of economic value in the process."[12] These would be the "enterprises pursuing different institutional ends"[13] previously mentioned and labeled "hybrid enterprises" in this article.

Catholic Social Teaching and the Purpose of the Firm

In response to these encyclicals, Catholic scholars have pondered the values underlying the modern firm and how methods of wealth creation might be channeled toward common welfare without undermining individual incentives. Alford and Naughton contrast the "shareholder model of the firm" with their own "common good model of the firm." They maintain that the discipline of finance has moved beyond a technique for profit maximization into a social philosophy that establishes profits as the chief end in and of itself. The consequence of this inflation of a means to an end is that the firm loses sight of its priorities. They cite Peter Drucker in support of the idea that "the purpose of business must not be found in business, but in society, since the enterprise is an organ of society."[14]

The principle behind organizing a firm is that in many instances it is cheaper for an entrepreneur to hire employees as opposed to contracting with suppliers because of transaction costs involving search for information, protection of trade secrets, and so forth.[15] The firm itself has been described as a "nexus of contracts"[16] that attempts to align the interests of managers with the interests of owners (stockholders). This is a response to agency theory—the idea that managers must be offered incentives by the owners (shareholders) or actively monitored by them in order to act in the best interests of the shareholders.[17] Compensation schemes for management tied to profit maximization are a popular way to resolve the principal-agent dilemma in the firm.

Alford and Naughton, along with Kennedy, contend that the roots of the firm extend beyond agency theory into classical liberal philosophies of the relationship of individuals to society. One assumption is that human beings are solitary creatures and that communities exist to serve their needs.[18] Kennedy writes that such an assumption is a direct outgrowth of the thinking of Hobbes and Locke and opposes the Catholic idea that communities are integral to authentic human development.

An important example of this difference concerns property rights. The modern firm rests on the notion of private property as an exclusive right. The Catholic view, dating back to Aquinas, is that private property carries not only rights to use but also an obligation to the common good. Private property is a second-best solution in a fallen world. Given this reality, the Church has vigorously championed private ownership[19] against the alternatives of socialism and communism; however, the nature of this defense differs from classical liberal philosophy. The Catholic view of property rights springs from a natural law[20] that God has ordained for humankind's enjoyment of what he has created,[21] whereas classical liberal philosophers such as Locke and Hobbes base their argument for property rights on a humanism that esteems individual rights, one of which is private ownership. The whole of neoclassical economic theory is far from being a disinterested study of *homo economicus*; it is a normative field with its own values (e.g., efficiency, equity) and judgments grounded in culture and society.[22]

As Clark explains, the Catholic concepts of efficiency and equity are quite different from the market-driven definitions that neoclassical economic theory proposes. Rather than directed toward utility or profit maximization, "the concept of efficiency must be defined in terms of meeting human needs … including needs that are non-material, such as spiritual needs or social participation."[23] Neoclassical economic theory presumes equitable outcomes because market transactions are assumed to be at arm's length, and participants, including laborers, will engage the market until marginal utility equals marginal cost. Catholic social teaching mandates that human beings, created in God's image, should have their basic needs met. Clark maintains that this is not a summons to "perfect equality; it supposes, rather, the goal that all be ensured the means to a decent standard of living."[24]

It is important to note that firms can grasp concepts such as property rights and efficiency while retaining notions of the common good. The point of the discussion thus far is to illuminate some of the differences in the respective philosophies that undergird Catholic social teaching versus neoclassical economics; indeed, to highlight that the latter approaches questions of social science with its own values and assumptions. As Kennedy articulates cogently, firms do support the common good when they furnish legitimate goods by legitimate means; they also create jobs and wealth for society via satisfying individual consumer needs. More efficient firms can certainly increase the common good; it is when efficiency (or property rights) becomes an absolute value that tension with Catholic social teaching occurs.

Prior writing has grappled with the purpose of the firm in the context of Catholic social thought. It is clear from this literature and from papal missives that profits, firms, and markets are not intrinsically evil; rather, their uses may be misdirected, owing to mankind's darkened reason.[25] This article builds on the literature by categorizing possible forms of hybrid firms, discussing institutional arrangements to support them, and exploring future research questions concerning them.

Differences Among Organizations Promoting the Common Good

There are a variety of actors charged with enhancing social welfare. We might differentiate them according to the primacy of their objectives (social, profit, or both) as well as their chief source of revenues.

By both law and norm, governments and the agencies they create should foster social welfare. A government agency may strive for efficiency, but it does not ordinarily consider profit as a motivator for action. Considered broadly, taxes, including fees, licenses, royalties, and debts that taxpayers service, provide the funding for operations.

A nongovernmental organization (NGO) is a voluntary, service-oriented or development-oriented organization that is entirely or largely independent of government and that have primarily humanitarian or cooperative instead of commercial objectives.[26] A nonprofit organization (NPO) is a type of NGO categorized by the fact that it is a legal entity exempt from taxes, such as an organization classified under Section 501(c)(3) under the U.S. Internal Revenue Code.[27] Both NGOs and NPOs share in common that they are organized primarily to advance noncommercial objectives. They do not forswear profits, but profit-making is not their raison d'être. Both also exist outside of business and government in civil society.

Hybrid businesses are self-reliant, unlike either NGOs or NPOs that require donations to fund at least part if not all of their operations. Their ability to continue as a going concern requires them to be competitive with firms that have profit maximization as either their only goal or their primary goal. Hybrids also differ from firms practicing corporate social responsibility. Many firms now recognize the value of corporate social responsibility and engage in environmental or humanitarian efforts in their communities, but these are not hybrid enterprises because such activities are clearly secondary to earning profits. Current examples of hybrid firms include "kingdom businesses" in evangelical Christian circles to spread the gospel and businesses associated with the Catholic Focolare Movement.[28] Businesses such as these consider profit as a means toward authentic human development rather than as an end in and of itself.

We can categorize different forms of hybrid enterprises. There are at least three types (see Table 2 on page 29). First, *socially conscious firms* are socially conscious firms that are publicly held[29] and offer a good or service for profit but divert substantial resources to a social purpose. The earnings are split among three stakeholders: retained earnings for future growth of the firm, a social dividend to support the common good, and a stockholder dividend. The ownership and organizational structure would be corporate. Second, s*ocially oriented firms* are socially oriented firms that are privately held and offer a good or service for profit, then divert a portion of the profit to retained earnings for future investment and a portion as a social dividend. The ownership and organizational structure could be a partnership or sole proprietorship. Third, s*ocial output firms* are social output firms that offer a good or service to advance social welfare (e.g., low-cost dentistry). Profits go to retained earnings because the pricing of the socially desirable good or service is kept low to maximize accessibility. For this type of firm, there generally would not be enough profit both to pay a separate social dividend and to continue as a going concern. This type is also privately held, and although it could be a partnership or sole proprietorship, it is more likely to be the latter.

Table 2: Types of Hybrid Firms

Type	Division of Profits	Ownership	Funding	Size (Employees)	Pricing
Socially Conscious	Retained earnings, social dividend, stockholder dividend	Public	Self, Debt, Equity	50–250+	Market
Socially Oriented	Retained earnings, social dividend	Private	Self, Debt	10–250	Market
Social Output	Retained earnings	Private	Self, Debt	1–50	Below Market

There are differing benefits and drawbacks among these types of hybrids. The socially conscious firm has more choices for financing and so faces fewer resource constraints on growth than the other two types. In terms of size, it would probably be classified as either a medium (50–250 employees) or large (250+ employees) enterprise as defined by the European Union.[30] Because of its ability to grow, the socially conscious firm has the potential to contribute more resources than the other two in an absolute sense but not on a per-capita basis. On the one hand, having stockholders means that the socially conscious firm must satisfy an additional constituency and comply with the rigorous financial reporting requirements imposed by the Securities and Exchange Commission (SEC) or similar body if the firm's shares are traded outside the United States.

Note that the difference between the socially conscious firm and a firm that engages in corporate social responsibility is one of degree rather than kind. What counts as substantial resources for social betterment obviously is a matter of interpretation and depends on contextual factors such as the position of the firm in its life cycle, competitiveness of the industry, and so forth. A new firm might not pay any dividends of any kind in the first few years as it struggles to survive yet still be committed both to a social purpose and to profits. There is no magic ratio of social dividends to total profits that would define a substantial commitment to the common good, but the pursuit of such must be a core principle backed with credible action.

For both socially oriented and social output firms, there is no need to satisfy the demands of stockholders. Not only does the management forgo the pressure implicit in quarterly earnings expectations, but they also avoid the onerous financial reporting requirements mentioned previously. On the other hand, the decision to forgo equity capital constrains financing options and growth. Only retained earnings or debt would be available to fund expansion.

The key difference between socially oriented and social output firms is in the pricing of the goods and services they sell. Socially oriented and socially conscious firms price according to what the market will bear, while social output firms price below market. The economic logic of the social output firm is to optimize the accessibility of the social good or service provided whilst accumulating enough profit to continue as a going concern. Pricing above the break-even point ensures that there will be sufficient retained earnings to replace equipment when it becomes obsolete, provide cost-of-living adjustments annually to employees, and so forth. Because of this pricing scheme, social output firms are likely to be the smallest of the three types.

Promoting Hybrid Firms

Beyond classifying the different types of hybrid firms, there is the issue of advancing them in society. This demands an assessment of institutional arrangements and how they might be configured (or reconfigured) toward this purpose. I use North's definition of *institution* as "the rules of the game in society."[31] Hybrid firms and other organizations are not institutions themselves by this definition; rather, they are players in the game responding to incentives and disincentives that institutions offer. Furthermore, it is useful to think of these institutions according to North's classification of "formal" (i.e., grounded in law, with official sanctions) and "informal" (i.e., based on norms, without legal sanction).[32] In practice, these types exist on a continuum and can overlap, but they offer a paradigm.

In terms of formal institutions, policymakers must take care that government does not crowd out hybrid firms either legally or financially. Government at the national and subnational levels should not only provide strong property rights and impartial rule of law, which benefits all businesses, but also define the mandates of their agencies clearly and specifically so as not to overrun private initiative. In addition, governmental bodies need to be fiscally responsible because budget deficits that are both chronic and acute require excessive taxation that enervates both profit-maximizing and hybrid firms alike.

The special mission of hybrids demands reexamination of tax policies. Because hybrids are pursuing profits along with social goals, governments may see fit to tax them. On the other hand, hybrids are not exclusively profit maximizing, so it seems unfair to tax them at the same rate as traditional enterprises. Perhaps a new tax rate at half the average corporate rate would be a starting point for considering taxation of hybrids. Tax-exempt status may be more applicable for social output firms, in which case the only difference between them and nonprofit organizations would be the latter's reliance on donations.

Socially conscious firms can benefit from existing financial institutions more so than the other types because they are publicly traded. They also should take advantage of the growing trend of socially responsible investing (SRI) by advertising their shares to mutual funds specialized toward this niche.[33] Tax incentives might be offered to shareholders such as making the dividends of these firms tax-exempt. Banks likewise might be given tax credits to offset any interest income from loans to socially oriented or social output firms, if not all three types of hybrids.

The greater impact of the two kinds of institutions rests with the informal. For starters, there needs to be a robust civic space where both religious and secular organizations can advocate hybrid firms to customers, investors, and other stakeholders. This is the obverse of government restraint mentioned previously and involves more than private freedom of conscience. It involves easy access to the public sphere where groups such as churches can articulate new norms regarding the purpose of business in society and how hybrid enterprises fill this role. There needs to be a public conversation about authentic human development.

Besides this, systems of education, particularly business education, should promote hybrid firms as a viable career. Entrepreneurship centers and curricula are now ubiquitous at business schools. The notion of social entrepreneurship, recombining inputs in novel ways for the advancement of the common good, is gaining currency. Hybrid firms represent a unique form of such entrepreneurship.

Future Directions

The purpose of this article is to consider different types of hybrid enterprises and the institutions needed to support them. As stated at the outset, this article is only the start of the conversation. There are a number of questions deserving of further research.

Within hybrid firms, this article raises two salient questions. The first is the division of profits: How can the social dividend be optimized given the constraints of other claims and in the context of the firm's industry, life cycle, and so forth? The second is with respect to social output firms: What is the optimal pricing of goods and services to allow maximum access while still providing for the firm's survival as a going concern? This article discusses these questions conceptually but does not provide either mathematical or empirical answers.

Outside of hybrid firms, there are a number of questions for future work. How should governments handle taxation of hybrid enterprises? What is the best way for advocates of hybrids to engage the public? How might business schools instill an appreciation for hybrid firms in their students, the entrepreneurs of tomorrow? These and many other issues are fertile ground for those interested in hybrid firms as a vehicle for authentic human development.

Notes

1. Manfred Spieker outlines a comprehensive approach to authentic human development in "Development of the Whole Man and of All Men: Guidelines of the Catholic Church for Societal Development," *Journal of Markets & Morality* 13, no. 2 (Fall 2010): 263–78. This article is not as ambitious in its scope; it concentrates on economic development and the role firms can play in connecting it to authentic human development.
2. Benedict XVI, Encyclical Letter, *Caritas in Veritate* (2009).
3. In this endeavor the article is continuing the thread of conversation that Guitián offered in his recent article, "Integral Subsidiarity and Economy of Communion: Two Challenges from *Caritas in Veritate*," *Journal of Markets & Morality* 13, no. 2 (Fall 2010): 279–95. I will differentiate among types of hybrid firms whereas Guitián emphasized the link between subsidiarity and economy of communion businesses, which I consider as one type of hybrid firm.
4. R. G. Kennedy, *The Good That Business Does* (Grand Rapids: Acton Institute, 2006), 41.
5. Leo XIII, Encyclical Letter, *Rerum Novarum* (1891).

6. Paul VI, Encyclical Letter, *Populorum Progressio* (1967), 14 and 16.
7. Paul VI, *Populorum Progressio*, 16.
8. Benedict XVI, *Caritas in Veritate*, 10.
9. Ibid., 8.
10. Ibid., 19–20.
11. Ibid., 32. (Italics in the original.)
12. Ibid., 37.
13. Ibid., 38.
14. Ibid., 34.
15. R. Coase, "The Nature of the Firm," *Economica* 4, no. 16 (1937): 386–405.
16. M. C. Jensen and W. H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure," *Journal of Financial Economics* 3, no. 4 (1976): 305–60.
17. K. M. Eisenhardt, "Agency Theory: An Assessment and Review," *Academy of Management Review* 14, no. 1 (1989): 57–74.
18. R. G. Kennedy, "The Virtue of Solidarity and the Purpose of the Firm," in *Rethinking the Purpose of Business: Interdisciplinary Essays in the Catholic Social Tradition*, ed. S. A. Cortright and M. J. Naughton (Notre Dame, Ind.: University of Notre Dame Press, 2002), 48–64.
19. Cf. Leo XIII, *Rerum Novarum*, 4, 9, 13.
20. *Natural law* is a term that can be defined in several different ways (cf. Hittinger, 2003). I am using it in the Thomistic sense outlined by Johnston as a law beyond the power of the state and therefore distinct from positive law enacted by legislatures or fiat. Johnston notes that the fiduciary duty of managers springs from the natural law; his work is another illustration, along with papal teachings regarding property rights, of how natural law is conducive to entrepreneurship and business. I thank an anonymous referee for this insight. Another benefit of natural law to business is rule of law (Hittinger, 2007), which decreases the likelihood of state expropriation of rents. See F. R. Hittinger, *The First Grace: Rediscovering Natural Law in a Post-Christian World* (Wilmington, Del.: ISI Books, 2003); J. F. Johnston Jr., "Natural Law and the Fiduciary Duty of Business Managers," *Journal of Markets & Morality* 8, no. 1 (Spring 2005): 27–51; F. R. Hittinger, *Thomas Aquinas and the Rule of Law—Tomamaso D'Aquino e La Rule of Law* (Soveria Mannelli: Rubbettino, 2007).
21. Leo XII, *Rerum Novarum*, 8–9.

22. Nelson (2001) makes this point about values and economics quite forcefully. He quotes another economist, Paul Heyne, asserting that "any economist who is trying to understand the world of human interactions with the hope of making them more effective is very likely to be operating with a *theological vision*" (p. 117, italics his). See R. H. Nelson, *Economics as Religion: From Samuelson to Chicago and Beyond* (University Park: Pennsylvania State University Press, 2001); T. Veblen, *The Theory of the Leisure Class* (New York: Penguin, 1899); G. Myrdal, *Value in Social Theory* (London: Routledge, 1958); A. Yuengert, *The Boundaries of Technique: Ordering Positive and Normative Concerns in Economic Research* (Lanham, Md.: Lexington Books, 2004).

23. C. M. A. Clark, "Competing Visions: Equity and Efficiency in the Firm," in *Rethinking the Purpose of Business: Interdisciplinary Essays in the Catholic Social Tradition*, ed. S. A. Cortright and M. J. Naughton (Notre Dame: University of Notre Dame Press, 2002), 95.

24. Ibid.

25. Benedict XVI, *Caritas in Veritate*, 36.

26. Excerpt from *How the World Bank Works with Non-Governmental Organizations* (1990), accessed at The Global Development Research Center: http://www.gdrc.org/ngo/wb-define.html.

27. The Citizen Media Law Project (2007) "Nonprofit Organization" accessed at http://www.citmedialaw.org/legal-guide/nonprofit-organization.

28. I am indebted to an anonymous referee for these illustrations of hybrid firms. Guitián (2010) refers specifically to the Focolare Movement in his discussion of economy of communion businesses; see note 2 above.

29. I am using *publicly held* here in the way commonly understood in the United States: A corporation with shares available to the public for ownership. Public ownership in other national contexts can mean state ownership; that is, a state-owned enterprise (SOE).

30. European Commission (2003) Recommendation 2003/361/EC: Definition of SMEs Policy areas, Enterprise and Industry, accessed at http://ec.europa.eu/enterprise/enterprise_policy/sme_definition/index_en.htm.

31. D. North, *Institutions, Institutional Change, and Economic Performance* (Cambridge: Cambridge University Press, 1990).

32. Ibid.

33. Cf. http://www.socialfunds.com/.