Hastings Race and Poverty Law Journal

Volume 13
Number 2 *Summer 2016*

Article 3

Summer 2016

The Fourth Sector: Creating a For-Profit Social Enterprise Sector to Directly Combat the Lack of Social Mobility in Marginalized Communities

Carlos Jurado

The Fourth Sector: Creating a For-Profit Social Enterprise Sector to Directly Combat the Lack of Social Mobility in Marginalized Communities

CARLOS JURADO*

Introduction

For decades, the majority of Americans unknowingly lost the ability to obtain the "American Dream." In fact, Americans offered no significant resistance as the American Dream was methodically placed beyond their reach by corporate-inspired public policy. The nation is now facing a severe income inequality crisis. As a result,

* J.D. Candidate, University of California Hastings College of the Law, 2016; B.A., University of California, Berkeley, 2011. Thank you to Professor Manoj Viswanathan for providing me unconditional support throughout my writing process. This Note would not have been possible without your great feedback and advice. Thank you to Professor Alina Ball for introducing me to the notion of Social Enterprises and for driving my passion for social change through a nontraditional forum. Your contagious passion and pedagogical approach were instrumental in my desire to write this Note. Thank you to Mrs. Germaine Clancy and Mr. Michael Clancy for pushing me toward education and supporting me during my initial pursuit of higher education. Thank you to my son, Romeo, and my daughter, Veronica, for being my biggest fans from the first moment I decided to pursue higher education. Thank you to my brother, Gerardo, my sister, Carolina, my Tios, Chuy, Rogelio, and Victor, and the rest of my family. You have all, in one way or another, been an amazing support system and I will always be indebted to you. Thank you to Mrs. Bridget Lemieux and Mr. Donald Lemieux for your love and your support of my commitment to the study of law. To my life partner, Whitney, thank you for all the love, support, and patience you gave me during the creation of this Note and throughout law school. Lastly, gracias mamá y papá por su amor, apoyo, y todo el sacrificio que han hecho para que yo siguiera con mi sueño de ser abogado.

there is a general lack of social mobility, which is especially harsh on marginalized communities and people of color. Consequently, there is the need for the creation of a sustainable mechanism that will work to alleviate the effects of current high rates of income inequality.

This Note addresses the need for the formal creation and growth of a fourth sector, the For-Profit Social Enterprise sector, as a viable solution to the lack of social mobility amongst marginalized communities. In doing so, this Note will explain how the three sectors of the American market—the government, private, and nonprofit sectors—have enabled current high rates of income inequality as a result of either a failure or purposeful scheme to sway the market in favor of a few elite. In addition, this Note discusses specific goal-oriented social mobility approaches that can be implemented by For-Profit Social Enterprises (FPSEs) to more efficiently allocate resources and measure success. Lastly, this Note proposes For-Profit Social Enterprise public policies to strengthen regulatory schemes, create an oversight agency, incentivize social entrepreneurship, maintain and grow the FPSE sector, and incentivize private social investors.

I. Origins of the Need for the Fourth Sector

The current income inequality crisis in the United States has created the need for a fourth sector that is capable of alleviating the general lack of social mobility amongst members of marginalized communities. Since the late 1970s, the United States has seen a shift in how income is distributed.[1] In the last three decades, the American economy has grown by about one hundred percent, while the average American citizen experienced no substantial earnings growth.[2] The average American chief executive officer (CEO) of a large corporation currently earns approximately 200 times the amount of the average worker and the richest one percent of Americans take about twenty percent of total income.[3] Although the issue of income inequality is sobering on its own, income inequality is especially worrisome

1. ROBERT B. REICH, SAVING CAPITALISM xi (2015).
2. *Id.*
3. REICH, *supra* note 1, at xi.

because of its chilling effect on social mobility.[4] Moreover, low rates of social mobility can have the effect of collapsing the middle class, which is responsible for propelling our economy.[5]

Although the issue of income inequality was recently brought to the general public's eye through the Occupy Wall Street movement,[6] the issue was not new to those in power.[7] For instance, in a congressional hearing regarding income inequality in the United States, Minnesota Senator Amy Klobuchar acknowledged that "income inequality in the United States has been growing for more than three decades and is now near a record high"[8] and that "the top 400 people in this country have more wealth than half of America."[9] Like Senator Klobuchar, there are many legislators who understand that American policies have played a vital role in enabling the conditions that have led to current income inequality rates. However, of those legislators who understand that American public policies have enabled high rates of income inequality, few publicly acknowledge the problem because of political implications. Further, those who intend to address the issue do not understand how and where to begin. Nevertheless, it is important that the American public understand the potential impact continued high rates of income inequality can have on the nation's economy and overall well-being

4. *Income Inequality in the United States*, *Hearing Before the Joint Econ. Comm.* 113th Cong. 76 (2014) [hereinafter *Hearing*] (statement of Melissa S. Kearney, Dir., The Hamilton Project, Brookings Inst.).

5. Robert B. Reich, *The Limping Middle Class*, N.Y. TIMES, Sept. 3, 2011, at SR6.

6. The Occupy Wall Street movement ("Movement") began in 2011. The Movement, which encompassed people from a plethora of backgrounds, came together to rally against the socioeconomic injustice that was rampant throughout America. The Movement challenged the status quo wherein, at the time, households in the top one percent captured ninety-nine percent of the country's total income gains, while incomes for the rest of the country were at their lowest in fourteen years. Consequently, most Americans had less of an opportunity for social mobility while poverty rates had increased to the point that one-third of all Americans were living in poverty or earned low-income wages. *See* OCCUPY WALL STREET, http://occupywallst.org/about/ (last visited Mar. 30, 2016).

7. *See Hearing*, *supra* note 4.

8. *Id.*

9. *Id.*

in order to grasp why it is indispensable to resolve the issue.

A. Income Inequality Exacerbates the Lack of Social Mobility

The United States must combat income inequality because of its adverse effect on social mobility. Experts have uncovered a correlation between high rates of income inequality and low rates of social mobility.[10] Low social mobility rates are detrimental to the nation's economy because they stretch the income ladder, causing a few to overwhelmingly benefit, while at the same time causing the middle class, the driving force of our economy, to diminish in size, and the lower class to grow substantially.[11]

As income inequality figures began to rise beginning in the 1980s, rates of intergenerational mobility, the rate of upward mobility between parents and their offspring, declined sharply from the rates that had prevailed from 1950 to 1980.[12] This sharp decline was likely due to the change in income distribution. In fact, from 1979 to 2007, middle class income rose by thirty-five percent, while incomes for the top one percent rose by 278 percent.[13] Sadly, this income distribution trend has continued. The United States is currently ranked sixty-fourth in the world in terms of income inequality[14] and studies have shown that "[t]he nations with high [income] inequality have the slowest social mobility."[15] Further, as Robert Reich explained, "even if you take the heroic assumption that the velocity—that is, the rate of upward mobility—is the same today as it was thirty or forty years ago . . . you can see logically how as the income and wealth ladder get longer and longer . . . you are not going to get too far up that ladder."[16]

10. *Hearing*, *supra* note 4, at 7 (statement of Robert Reich).

11. *Id.*

12. Thomas W. Mitchell, *Growing Inequality and Racial Economic Gaps*, 56 HOW. L.J. 849, 863 (2013).

13. HEATHER BOUSHEY & ADAM S. HERSH, CTR. FOR AM. PROGRESS, THE AMERICAN MIDDLE CLASS, INCOME INEQUALITY, AND THE STRENGTH OF OUR ECONOMY 1 (2012).

14. *Hearing*, *supra* note 4, at 2 (statement of Amy Klobuchar, Vice Chair, U.S. Sen. from Minn.).

15. *Id.* at 7 (statement of Robert Reich).

16. *Hearing*, *supra* note 4, at 7.

As the income inequality gap grows wider, it becomes increasingly difficult for individuals to obtain upward mobility because the next socioeconomic level is at an increasingly distant reach.

Consequently, the rate of intergenerational upward social mobility has remained stagnant over the last few years and, more than ever, a parent's socioeconomic status has become increasingly indicative of its offspring's future status.[17] A study by the Brookings Institute found that forty-two percent of children born into the bottom fifth quintile of income remained in the bottom fifth as adults, thirty-nine percent of children born into the top percentile remained at the top, and only six percent of children born into the bottom quintile moved to the top.[18] Moreover, the study found that children born into middle-income families had a "near equal likelihood" of moving into any other quintile.[19] These figures are significant because they indicate that the poor are likely to remain in low socioeconomic levels while members of the middle class are also likely to mobilize out of middle class status. As a result, the middle class has continued to diminish in size and may soon stop being the driving force of our economy.

B. The Middle Class as the Driving Force of the Economy

Over the course of American history, the middle class has played a crucial role in the development and maintenance of the economy. For instance, Reich noted that during the three decades that followed World War II (WWII), "America created the largest middle class the world had ever seen. During those years, the earnings of the typical American worker doubled, just as the size of the American economy doubled."[20] In the years after WWII, the American economy was booming and the middle class was the driving force behind the

17. Julia B. Isaacs, *Economic Mobility of Families Across Generations*, *in* BROOKINGS INST., GETTING AHEAD OR LOSING GROUND: ECONOMIC MOBILITY IN AMERICA 1, 7 (2008).

18. *Id.*

19. *Id.*

20. REICH, *supra* note 1, at xi.

thriving economy.[21] This period of time demonstrates that a strong middle class propels the economy in a variety of ways, including: the development of more educated population, the development of future entrepreneurs, and the development of inclusive political and economic institutions such as unions.[22] More importantly, a strong middle class creates a demand for goods and services.[23]

Historically, the middle class has been responsible for most of the demand and spending in the economy.[24] However, with a smaller and weaker middle class the economy suffers due to the lack of sufficient members in the market for goods and services.[25] As some scholars noted, the vicious cycle is felt throughout the economy as businesses will only invest "if they are confident that they will be able to sell their products at a profit. Yet families will not be able to consume or make investments in themselves and their children if they have insufficient incomes or are financially insecure."[26] Moreover, our current income distribution system allows for top earners to hoard large amounts of wealth and, because there is a very limited number of top earners, they are unable to spend enough money to drive our economy.[27] Without the spending power of the middle class, the economy will lose its main catalyst and the mechanisms that propel the economy will become stagnant and fail. Consequently, it is crucial that we work to diminish the current high rates of income inequality in order to strengthen and maintain the middle class, as America once did in the past when its economy was booming.

21. REICH, *supra* note 1, at xi.
22. BOUSHEY & HERSH, *supra* note 13, at 9–43.
23. *Id*. at 4.
24. Reich, *supra* note 5.
25. BOUSHEY & HERSH, *supra* note 13, at 25.
26. *Id.* at 24.
27. *Id.* at 26–27.

C. High Rates of Income Inequality Are Especially Troublesome to People of Color

Wide disparity in income distribution is additionally problematic when we recognize that people of color are disproportionately affected. In 2014, the real median income ratio of African Americans to Whites was 0.59.[28] For Latinos, the ratio of real median income compared to that of Whites was 0.71.[29] Although the incomes of all three groups fell as a result of the recession, data from 2014 shows that since 2001, white household incomes have suffered a decline of four percent, while African-American and Latino households suffered income declines of 13.2 percent and 6.8 percent respectively.[30] These exaggerated effects on minority communities have also translated into a lower rate of upward social mobility in comparison to Whites. Data from 1971-2010 indicate that "[i]f we consider African-Americans' absolute income, rather than their relative position within the income distribution, new research shows virtually no improvement over time."[31]

> [A] majority of African-Americans whose parents were in the middle class have fallen downward into a lower segment of today's income distribution.[32] Whereas White children raised in middle and upper-income families have much higher income than their parents when they reach adulthood, Black children raised in similar families have substantially lower income than their parents.[33]

Moreover, these disproportionate rates of social mobility are especially alarming when we consider that only 10.1 percent of Whites live in poverty, compared to 26.2 percent and 23.6 percent of African

28. CARMEN DENAVAS-WALT & BERNADETTE D. PROCTOR, U.S. CENSUS BUREAU, INCOME AND POVERTY IN THE UNITED STATES: 2014, at 7 (2015).

29. *Id.*

30. *Id.*

31. PATRICK SHARKEY, STUCK IN PLACE: URBAN NEIGHBORHOODS AND THE END OF PROGRESS TOWARD RACIAL EQUALITY 3 (2013).

32. *Id.* at 4.

33. *Id.*

Americans and Latinos respectively.[34] Together, such data illustrates that although most of America is suffering due to the unequal distribution of income, minorities are far less likely to ascend to the middle class or to retain their middle class status under current economic conditions.

The consequences of this continued economic trend are alarming. Decades of disproportionate income inequality have enabled the creation and growth of high poverty neighborhoods that are largely inhabited by people of color.[35] These neighborhoods are faced with social isolation, high rates of poverty crimes, aggressive policing, and generally lack access to the private sector, which creates a lack of access to the mainstream economy.[36] Without an active mitigating solution, this economic segregation will continue to perpetuate the existence and growth of high poverty neighborhoods and the disproportionate lack of social mobility amongst people of color.

D. The Optimal Amount of Income Distribution

The current rates of income inequality are dangerously high and detrimental to our economy and the welfare of the United States. Yet, it is unconceivable to embark on a quest to find an ideal distribution of income. However, we can look back to American history to the years between the end of WWII and the late 1970s to assess what the income distribution rate was when the American economy and American capitalism was beneficial to most members of society.

> [F]or three decades after World War II, the average hourly compensation of American workers rose in lockstep with productivity gains. It was a virtuous cycle, from which our family and tens of millions of others benefitted: as the economy grew, the middle class expanded, as its

34. DENAVAS-WALT & PROCTOR, *supra* note 28, at 14.

35. Alina Ball, Comment, *An Imperative Definition of "Community": Incorporating Reentry Lawyers to Increase the Efficacy of Community Economic Development Initiatives*, 55 UCLA L. REV. 1883, 1894 (2008).

36. *Id.*

> purchasing power rose, the economy grew faster, spawning new investments and innovations that further enriched and enlarged the middle class.[37]

Studies have shown that during this time family income roughly doubled for everyone in the income distribution.[38] In fact, in this time, family income in the bottom four quintiles increased by approximately 99.2 percent, while income for those in the top five percent increased by 85.5 percent.[39] In comparison, during the years of 1979 and 2007, middle class income rose by thirty-five percent, while incomes for the top one percent rose by 278 percent.[40] The disparity in these figures is alarming and demonstrates how far the United States has moved away from the days when the market was advantageous for most Americans. Therefore, we can use the figures from post-WWII to the late 1970s to provide an indication of what the United States should strive to attain in terms of income distribution. However, it is ultimately not necessary to identify an optimal amount of income distribution. Instead we can use these figures to understand that the current levels of income inequality are far too high.

II. How the Existing Three Sectors Have Enabled High Rates of Income Inequality

In arguing that a fourth sector is a viable and necessary solution to alleviate the lack of social mobility caused by income inequality, it is first necessary to discuss how the three existing sectors—private, government, and nonprofit—have enabled the conditions that have led to current high rates of unequal income distribution. An analysis of all three sectors will help us understand that, either by design or by

37. REICH, *supra* note 1, at 115.
38. Chad Stone et al., *A Guide to Statistics on Historical Trends in Income Inequality*, CTR. ON BUDGET & POL'Y PRIORITIES (Oct. 26, 2015), http://www.cbpp.org/research/poverty-and-inequality/a-guide-to-statistics-on-historical-trends-in-income-inequality.
39. Mitchell, *supra* note 12, at 853.
40. BOUSHEY & HERSH, *supra* note 13, at 1.

failure, all three sectors have, congruently, enabled the conditions that have led to the creation of a society where the top quintile continually accumulates wealth while those living in poverty will likely remain poor for the rest of their lives.

A. The Private Sector

Prior to the 1980s, the private sector was comprised of firms that were capable of creating profits while also providing acceptable living standards for their constituents through appropriate wages.[41] This was accomplished through a combination of legal regulations and bargaining powers that enabled company constituents to have significant control over their work treatment and compensation. For instance, the National Labor Relations Act of 1935 (NLRA) enabled the creation and growth of unions by providing workers the legal right to orderly election procedures and rules governing union formations.[42] In addition, the Treaty of Detroit, which was a bargaining agreement between General Motors and the United Auto Workers, set a significant bargaining pattern that called for wages to grow at the same rate as productivity and the cost of living.[43] Both the NLRA and the Treaty of Detroit played a part in providing company constituents with significant countervailing powers that they used to protect themselves from corporate greed.[44]

Beginning in the early 1980s the United States began to experience a downturn in corporate behavior and in the use of collective bargaining.[45] Competition from international and nonunion national companies, a widely publicized antiunion sentiment by the Reagan Administration, and a variety of other reasons, led to a growing number of wage concessions and an overall

41. Ronald Blackwell & Thomas Kochan, *Restoring Public Purpose to the Private Corporation* (Feb. 10, 2013), http://papers.ssrn.com/sol3/papers.cfm ?abstract_id=2214621.

42. *Id.* at 4–5.

43. *Id.*

44. *Id.*

45. *Id.* at 6.

hostility toward unionization.[46] Consequently, corporate executives stopped enforcing previously enacted regulations and began to make decisions that overwhelmingly favored shareholders and corporate executives.[47] Corporations once again asserted the view that maximizing profits and shareholder value were the main and, perhaps, the only purpose of the corporation.[48] This "shareholder value first" way of thinking was especially reflected in CEO compensation packages as they were more often mainly aligned with the creation of profit.[49] As a result, these new CEO compensation structures created incentives for the creation of profits without regard for company constituents. For instance, low wages and layoffs became a common preemptive means of ensuring profit margins were being met, instead of last resort strategies to keep the corporation afloat.[50] In addition, CEO compensation ballooned to unseen figures.[51] Whereas the CEO to average worker compensation ratio was 40:1 in 1970, that figure had grown to nearly 400:1 in 2005.[52]

For instance, in 2011 the average Wal-Mart employee earned $18,000 per year[53] while, Wal-Mart's former CEO, Michael Duke, earned an estimated $18,000 per hour.[54] To understand the magnitude of the issue, we must consider that Wal-Mart is the biggest private United States employer with 1.3 million employees.[55] However, Wal-Mart is just one of the top one hundred corporations that has grown to employ fifty-three percent more employees between 1986 and

46. Blackwell & Kochan, *supra* note 41, at 6–7.

47. *Id*. at 7.

48. *Id.*

49. *Id.*

50. *Id.*

51. *Id.* at 8.

52. *Id.*

53. Sarah Jaffe, *CEO of Wal-Mart Makes in One Hour What the Average Employee Makes In a Year: How Skyrocketing Inequality Is Hurting America*, ALTERNET (June 20, 2011), http://www.alternet.org/story/151351/ceo_of_walmart_makes_in_one_hour_what_the_average_employee_makes_in_a_year%3A_how_skyrocketing_inequality_is_hurting_america.

54. *Id.*

55. Neil Irwin, *As Wal-Mart Gives Raises, Other Employers May Have to Go Above Minimum Wage*, N.Y. TIMES, Feb. 19, 2015, at BU6.

2010.[56] In fact, businesses that employed 500 or more individuals provided fifty-one percent of all employment in the United States in 2011.[57] Furthermore, wage inequality trends remain constant across many large corporations.[58] Wage data from large corporations indicate that the CEOs of these entities earned, on average, 343 times more than the average workers of their respective companies.[59] This data is especially troublesome when we consider that there is a correlation between the growth of large corporations and the growth of income inequality.[60]

Unfortunately, large corporations are likely to continue dominating the market due to favorable public policy and tax laws, and, more importantly, a lack of competition. The lack of competition has been caused by a low ratio of "Business Dynamism."[61] Business Dynamism is described as "the process by which [companies] continually are born, fail, expand, and contract, as some jobs are created, others are destroyed, and others still are turned over."[62] In short, Business Dynamism is the ratio of the creation of new businesses versus the end of others.

According to a Brookings Institute study, Dynamism is at an all-time low in America.[63] Entrepreneurs are no longer taking risks by starting new businesses and have instead acquired employment with

56. *The Bigger, The Less Fair*, ECONOMIST (Mar. 14, 2015), http://www.economist.com/news/finance-and-economics/21646266-growing-size-firms-may-help-explain-rising-inequality-bigger.

57. Nikelle Murphy, *Are Big Companies Driving Income Inequality?*, CHEATSHEET (Apr. 2, 2015), http://www.cheatsheet.com/business/why-big-companies-are-driving-income-inequality.html/?a=viewall.

58. George Zornick, *Large, Profitable Companies Employ Most Minimum-Wage Earners*, NATION (July 19, 2012), http://www.thenation.com/article/large-profitable-companies-employ-most-minimum-wage-earners/.

59. Jaffe, *supra* note 53.

60. Murphy, *supra* note 57.

61. Ian Hathaway & Robert E. Litan, *Declining Business Dynamism in the United States: A Look at States and Metros*, BROOKINGS INST. (May 2014), http://www.brookings.edu/research/papers/2014/05/declining-business-dynamism-litan.

62. *Id.*

63. *Id.* at 6.

other companies.[64] While the United States had constantly maintained a positive ratio of new businesses versus businesses that had been shut down, the United States experienced its first negative Dynamism ratio in 2010; this meant that the United States market had experienced more business deaths than births.[65] This downward trend in company births indicates that large corporations are currently experiencing less competition. Without competition, large corporations will continue to run their operations in a manner that will allow them to increase their profit margins. In other words, corporations will continue paying their executives high salaries while continuing to pay their employees low wages. As history has shown, a thriving private sector under current market conditions and regulations, will likely mean that income inequality rates will continue to climb.[66]

B. The Government Sector

The government has been complicit in the creation of current rates of income inequality due both to direct action and to a failure to properly mitigate the existing high rates of income inequality. The government has acted directly through the political process by embracing a political culture where wealth equals political influence and power over the structure of the market. Additionally, it has failed to mitigate the effects of an uneven market through its ineffective anti-poverty spending programs.

1. How the Political Process Has Shaped the Market

The notion of a "free market" is false, misleading, and dangerous.[67] In fact, it creates a thriving forum for erroneous and problematic discussions of "meritocracy" where the market takes a

64. Hathaway & Litan, *supra* note 61, at 6.
65. Hathaway & Litan, *supra* note 61, at 1.
66. *See supra* Part 1.
67. REICH, *supra* note 1, at 1.

Darwinist role.[68] The "free market" narrative asserts that individuals earn what they deserve.[69] It assumes the market unbiasedly compensates those who are best fitted and punishes the unfit with low wages or unemployment.[70] However, the truth is that the market does not exist without the rules and regulations enacted by the government.[71] The market was synthetically created and is maintained by the United States government through the political process.[72] Consequently, the market is maintained and shaped through the decisions of elected officals with legislative power.[73] In essence, our nation's political process is the forum through which our government makes decisions regarding what is acceptable and what should be outlawed in the market.[74] It is through this political process that the market has been substantially tilted to benefit the wealthy.[75]

a. The Influence of the Wealthy on Elected Officials

Wealthy individuals and large corporate interest groups are, almost solely, responsible for shaping American policies.[76] This is mostly due to the fact that a few wealthy individuals and corporate interest groups are by far more willing and able to make significant campaign contributions to politicians.[77] Campaign contributions are crucial to politicians. In fact, most successful political campaigns are driven by well-endowed campaign funding.[78] This constant

68. REICH, *supra* note 1, at 1.

69. *Id.*

70. *Id.*

71. *Id.*

72. *Id.* at 4.

73. *Id.* at 5.

74. *Id.* at 82.

75. *Id.* at 81.

76. Martin Gilens & Benjamin I. Page, *Testing Theories of American Politics: Elites, Interest Groups, and Average Citizens*, 12 PERSP. ON POL. 564, 573–74 (2014).

77. Nicholas Confessore, Sarah Cohen & Karen Yourish, *Small Pool of Rich Donors Dominates Election Giving*, N.Y. TIMES (Aug. 1, 2015), http://www.nytimes.com/2015/08/02/us/small-pool-of-rich-donors-dominates-election-giving.html?_r=0.

78. Wesley Lowery, *91% of the time the better-financed candidate wins. Don't act surprised.*, WASH. POST (Apr. 4, 2014), https://www.washingtonpost.com/news/the-fix/wp/

fundraising activity opens the door to campaign financing in exchange for future consideration. In effect, campaign donations enable the likelihood that candidates will be vulnerable to the preferences of their donors when it comes to making future legislative decisions if they are elected to office. This creates the unspoken, but well-known, practice of *quid pro quo*, exchanging campaign contributions for political influence. Since this process can be simplified as the legal exchange of money for political favors, and given the fact that the recent decision of *Citizens United v. FEC*[79] made any campaign spending limitations on organizations unconstitutional, it follows that those with more money to spend on campaign contributions will have more influence on legislative decisions.

One study found that legislators mostly acquiesced to the interests of the wealthy and their special interest groups.[80] More importantly, this study found that, for the most part, average Americans lost when they opposed the position of the wealthy and their special interest groups.[81] This study concluded that "economic elites and organized groups representing business interests have substantial independent impacts on United States government policy, while mass-based interest groups and average citizens have little or no independent influence."[82] Consequently, "decisions are more often hashed out behind closed doors, in negotiations influenced disproportionately by giant corporations, big banks, and wealthy individuals with enough resources to be heard."[83] Therefore, the market has been shaped and maintained to better suit the needs and preferences of those who are and wish to remain at the top of the wealth ladder. Ultimately, the government's political process has been implicit in allowing the market to be regulated in a manner that enables high rates of income inequality.

2014/04/04/think-money-doesnt-matter-in-elections-this-chart-says-youre-wrong/.

79. Citizens United v. Fed. Election Comm'n, 558 U.S. 310 (2010).

80. Gilens & Page, *supra* note 76, at 575–76.

81. *Id.* at 575.

82. *Id.* at 565.

83. Reich, *supra* note 5, at 82.

2. The Government's Spending Programs

Although the government has recognized the problem of high-income inequality and has aimed to mitigate the issue through government spending programs, notwithstanding the fact that income inequality would be more severe in the absence of current programs, it has failed to find a viable solution. The government's spending programs such as the Temporary Assistance for Needy Families program (TANF) and the Supplemental Nutrition Assistance Program (SNAP, formerly known as "Food Stamps") are part of the government's "war on poverty."[84] However, these programs have failed to create any significant permanent improvement in the lives of those they have targeted.[85] Nevertheless, it is important to comprehend the government's most successful attempt at mitigating income inequality, through the "Earned Income Tax Credit" program (EITC), in order to understand how government programs are incomplete solutions to addressing the widening income inequality gap problem.

a. The EITC as an Inefficient Solution to the High Rates of Income Inequality

The EITC provides a refundable tax credit that is given to low-income families in proportion to their income.[86] The tax credit is phased out as earned income rises.[87] Families that have earned incomes over a certain limit will not be eligible for the refundable credit.[88] The EITC is currently the government's biggest antipoverty measure.[89] It has been the fastest growing antipoverty measure since

---

84. THE WAR ON POVERTY: 50 YEARS LATER, A HOUSE BUDGET COMMITTEE REPORT 7–9 (2014).

85. *Policy Basics: An Introduction to TANF*, CTR. ON BUDGET & POL'Y PRIORITIES, http://www.cbpp.org/research/policy-basics-an-introduction-to-tanf (last updated June 15, 2015).

86. 26 U.S.C. § 32 (2015).

87. *Id.*

88. *Id.*

89. Susannah C. Tahk, *The Tax War on Poverty*, 56 ARIZ. L. REV. 787 (2014).

the 1980s.[90] It is estimated that the government spent a total of $69.2 billion on the EITC program in 2014.[91]

The EITC was first enacted during the Nixon administration as a means to ensure that all working families had a minimum income.[92] Since then, the EITC has experienced constant substantial growth.[93] This is in large part due to the program's appeal to both Democrats and Republicans. The EITC is agreeable amongst Republicans because it incentivizes labor, while Democrats also advocate for the EITC because it provides a subsidy for families in lower socio-economic levels.

Although the program has experienced relative success in comparison to the government's other spending programs, it has failed to substantially bridge the income inequality gap. For instance, it is estimated that the EITC was able to fill the poverty gap[94] by 5.4 percent in 2013.[95] Although this is a larger percentage than TANF, which is estimated to have filled the poverty gap by 2.5 percent in 2004,[96] and all other current antipoverty programs, it is still miniature compared to the 21.7 percent that, TANF's predecessor, the "Aid to Families with Dependent Children" program (AFDC) used to fill.[97]

In addition, studies have demonstrated that the EITC was especially ineffective when it came to positively affecting the economic situation of individuals belonging to the lowest socio-

90. John K. Scholz, Robert Moffitt & Benjamin Cowan, *Trends in Income Support*, 26 UNIV. WIS. INST. FOR RES. ON POVERTY 43, 47 (2009).

91. Staff of Joint Comm. on Taxation, 113th Cong., Estimates of Federal Tax Expenditures for Fiscal Years 2014-2018, JCS-1-13 45 (Comm. Print 2014).

92. CHRISTOPHER HOWARD, THE HIDDEN WELFARE STATE 65–69 (Princeton U. Press 1997).

93. Chris Edwards & Veronique de Rugy, *Earned Income Tax Credit: Small Benefits, Large Costs, Cato institute* (Oct. 14, 2015), http://www.cato.org/publications/tax-budget-bulletin/earned-income-tax-credit-small-benefits-large-costs.

94. "Poverty Gap" is defined as the sum of the differences between market income and the poverty line for all families with incomes below the poverty line. *See* Scholz et al., *supra* note 90, at 44.

95. Tahk, *supra* note 89.

96. Scholz et al., *supra* note 90, at 45.

97. Tahk, *supra* note 89.

economic status.[98] This is a consequence of the EITC distributive criteria, which allows for a large distribution of the funds to families above the poverty limit and keeps some of those at the lowest levels of poverty from benefitting from the tax credit because it demands that individuals have an earned income in order to qualify for the program.[99] Consequently, those who are in most need of the EITC's safety net are disqualified and must depend on other, less effective, government anti-poverty programs.[100] In fact, the EITC was more effective in creating wealth in families that were closer to the phase-out level[101] of income than in those who had less income.[102] In the case of individuals with less income, the EITC enables them to maintain their current lifestyle by allowing them to pay debts and make repairs to necessary items that had gone unrepaired through the year.[103] Because only a small fraction of those who receive the EITC are able to accumulate enough income to obtain tangible wealth, it follows that the government's largest antipoverty program fails to substantially mend the income inequality gap in America.

C. The Nonprofit Sector

The nonprofit sector was created, in part, to close the gap that

98. Tahk, *supra* note 89, at 803.

99. H. Luke Shaefer & Kathryn Edin, *Rising Extreme Poverty in the United States and the Response of Federal Means-Tested Transfer Program* 6 (Nat'l Poverty Ctr., Working Paper No. 13-06, 2013), http://npc.umich.edu/publications/u/2013-06-npc-working-paper.pdf.

100. *Id.*

101. Tahk, *supra* note 89, at 799 ("The EITC statute restricts its benefits to low-income families by phasing out the credit for taxpayers whose adjusted gross income exceeds a phase-out amount. Above the phase-out amount, a taxpayer must reduce her otherwise available credit. She reduces it by the 'phase-out percentage' of the amount by which her adjusted gross income exceeds a statutorily set 'phase-out amount.'").

102. Stephanie Wagner, Building Assets, Building Futures: Does Receiving The Earned Income Tax Credit (EITC) Help Poor Single Mothers Build Assets For The Future? 34–35 (Apr. 18, 2007) (unpublished M.P.P. thesis, Georgetown University), http://handle.net/10822555843.

103. *Id.* at 35.

government services were unable to provide.[104] Nonprofit entities are formed for reasons others than to create profit. Hence, nonprofits do not have shareholders or equity holders. Most nonprofits are created for educational, health, or social purposes. In all, there are approximately 1.5 million tax-exempt nonprofits in the United States.[105] About 1.1 million are public charities,[106] 100,000 are private foundations,[107] and over 350,000 are other types of nonprofits.[108] Because public charities are the largest type of nonprofits, it is important to study their structure, funding, and how they contribute to the growth of income inequality rates in the United States.

1. Public Charities

Looking at the nonprofit sector through the lens of public charities, the most abundant type of nonprofit, we can understand that the nonprofit sector has and will continue to fail in its purpose of filling the societal needs gap left by the government. Section 501(c)(3) of the Internal Revenue Code provides that public charities include entities created to promote the arts, culture, and organizations created for the purposes of humanities, education, health care, human services, public and social benefit, amongst others.[109] Public charities are estimated to have received revenues in excess of $1.65 trillion in

104. Rickke Mananzala & Dean Spade, *The Nonprofit Industrial Complex and Trans Resistance*, 5 SEXUALITY RES. & SOC. POL'Y 53, 58 (2008).

105. *Quick Facts About Nonprofits*, NAT'L CTR. FOR CHARITABLE STAT., http://nccs.urban.org/statistics/quickfacts.cfm (last visited Mar. 15, 2016).

106. *Public Charities*, I.R.S., https://www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations/Public-Charities (last visited Mar. 15, 2016).

107. *Id.*

108. Other types of nonprofits include chambers of commerce, fraternal organizations and civic leagues, among others.

109. 26 U.S.C. § 501(c)(3) (2015).

2012.[110] Of the reporting public charities, 17.1 percent[111] were organizations created for purposes of education, thirteen percent[112] were health care organizations, and 11.6 percent[113] were organizations for public and social benefit.[114] However, the revenue for health care and educational organizations accounted for fifty-nine percent[115] and seventeen percent[116] of the total revenues for public charities in 2012 respectively.[117] Meanwhile, the revenue for public and social benefit organizations accounted for 5.6 percent of the total revenues for public charities.[118]

These figures demonstrate that, with the exception of education and health care public charities, most public charities have little funding. In fact, seventy-four percent of public charities do not have to report their finances because they have gross receipts of less than $50,000.[119] In other words, the large majority of public charities have relatively small operations. Consequently, this lack of sufficient funding changes work allocation within the organizations. Fundraising drives much of the organization's efforts and social missions take a backseat to the acquirement of funds. Furthermore, the organization comes together to stay afloat instead of seeking to advance their original purpose.

In addition, these figures show that 76.5 percent of the revenue created by public charities is going to health care and educational

110. BRICE S. MCKEEVER & SARAH L. PETTIJOHN, URB. INST. CTR. ON NONPROFITS AND PHILANTHROPY, THE NONPROFIT SECTOR IN BRIEF (Oct. 2014), http://www.urban.org/sites/default/files/alfresco/publication-pdfs/413277-The-Nonprofit-Sector-in-Brief--.PDF. This is not an exact figure because only 286,420 public charities had to report their finances. Tax-exempt nonprofits must report their finances only if their gross receipts for the year exceed $50,000.

111. *Id.* at 6.

112. *Id.*

113. *Id.*

114. *Id.*

115. *Id.*

116. *Id.*

117. *Id.*

118. *Id.*

119. *Id.*

organizations.[120] This is troublesome because in many instances health care and educational organizations follow a similar income distribution scheme as the large for-profit corporations.[121] According to Mark Rosenman,

> [S]ome nonprofit organizations have to pay differentials as large as some for-profit corporations. Scores of college officials take home over $1 million each year while twenty-two percent of their work force is at poverty-level wages for a family of four. In many nonprofit health institutions, disparities are even more extreme.[122]

This unequal distribution of income is, at least in part, caused by the infrastructure and the decision making processes of nonprofits.[123] Many nonprofits are often operated by those with race, class, and educational privilege.[124] Consequently, decisions as to compensation and how to best utilize time and resources of the organizations are concentrated in individuals who are likely not represented in the organization's target demographic.[125] Therefore, these decisions tend to resemble a meritocracy where those charged with making decisions will create compensation schemes that largely favor the very reason they were charged with making decisions.[126]

Further, in addition to creating unequal income distribution schemes, compensation and utilization of resource decisions have impacted the amount of funds that are actually used toward social missions.[127] After deducting the amount of money being compensated to the leadership and staff of nonprofits and paying overhead

120. MCKEEVER & PETTIJOHN, *supra* note 110, at 6.

121. Mark Rosenman, *Fighting Income Inequality Should Be Top Nonprofit Priority*, CHRON. PHILANTHROPY (Jan. 21, 2014), https://philanthropy.com/article/Fighting-Income-Inequality/153773.

122. Rosenman, *supra* note 121.

123. Mananzala & Spade, *supra* note 104, at 57.

124. *Id.* at 58.

125. *Id.* at 57.

126. *Id.* (arguing that compensation schemes will often provide higher value to education or experience).

127. *Id.* at 58.

costs, it is estimated that only a small amount is directly used for social purposes.[128] As Rickke Mananzala and Dean Spade observed, "more philanthropic dollars end up in the pockets of those with race, class, gender, and educational privilege[,]" such as lawyers, social workers, and people with degrees in nonprofit management.[129]

Looking through the lens of the public charity, it is evident that the nonprofit sector has been and will continue to be inefficient in resolving major social issues such as income inequality. While large health and educational organizations retain most of the public charity revenue, they fail to utilize that funding to promote income equality even within their own organization.[130] Instead, they choose to take on the corporate business model and perpetuate the effects of the private sector on society. On the other hand, smaller nonprofits are unable to create large changes because they are in a perpetual fight for additional funding to remain afloat and only cents of their funding dollars are used to directly address their social mission.[131] Consequently, it follows that the nonprofit sector is incapable of mending the wide gap of income inequality.

III. For-Profit Social Enterprises and Social Mobility

A. Defining "For-Profit Social Enterprise"

Although there is no generally accepted definition for the term "FPSE," for purposes of this Note, FPSE will be defined as "a self-sustaining for-profit business venture, which was created for the purpose of resolving a social issue through the use of funding generated by the main and deliberate business operations of the venture."[132]

128. Mananzala & Spade, *supra* note 104, at 58.

129. *Id.*

130. Rosenman, *supra* note 121.

131. Mananzala & Spade, *supra* note 104, at 58.

132. The term "social issue" will include, but is not limited to, economically empowering individuals from marginalized communities. The term "individuals from marginalized communities" will include people who are especially vulnerable to

B. For-Profit Social Enterprises as a Means of Creating Social Mobility

Independent of FPSEs' ability to eliminate or even mitigate income inequality, the assertion is that FPSEs can be used to enable social mobility amongst their respective constituents. By targeting communities that have proven to be disproportionately susceptible to current income inequality trends, a FPSE sector has the potential to become an exceptionally successful tool at alleviating the lack of social mobility in marginalized communities. Moreover, FPSEs can reach their goals with surgical precision as they can individually select their constituents and choose the most appropriate social mobility approach.

However, in attempting to enable social mobility, it is insufficient for FPSEs to ascertain broad social missions. For instance, a number of FPSEs maintain that their social mission is to provide employment opportunities to individuals from marginalized communities.[133] Unfortunately, broad social missions like these do not provide an actual goal. In fact, they fail to describe what FPSEs hope to achieve by providing employment opportunities to individuals from marginalized communities. Overall, FPSEs are correct in understanding that the economic empowerment of individuals from marginalized communities is important in attempting to create social mobility. Yet, FPSEs should further expand on their endeavors to express that economic empowerment is but a means to enabling social mobility. Although there is a wide range of definitions for social mobility, including, for example, "[t]he ability of citizens to move from one social class to a higher socioeconomic system,"[134] for

current market conditions, such as, but not limited to: the formerly incarcerated, former gang members, individuals living in poverty, recovering drug addicts, low income single parents, and individuals enrolled in government assistance programs. The term "government assistance programs" will include such programs as, but not limited to, welfare, food stamps, and WIC.

133. *See* EPAMADE, http://epamade.com/pages/about-us (last visited Apr. 8, 2016) ("EPAMade is a positive work community that trains and employs single mothers in order to see hope rise in East Palo Alto.").

134. Michelle D. Deardorff & Angela M. Kupenda, *Negotiating Social Mobility and*

purposes of this Note, I narrow the scope and define social mobility as "economically mobilizing individuals living in poverty[135] into the middle class."[136]

Any endeavor to enable social mobility should begin with an understanding of the underlying conditions that have and will continue to serve as barriers to social mobility in order to devise an appropriate approach. Thereafter, the FPSE should identify a specific group and qualify the target demographic according to one or more characteristics. Traits that are commonly found amongst those living in poverty, such as being previously incarcerated,[137] not holding a high school diploma,[138] being a low income single parent,[139] receiving government welfare benefits,[140] and others, should be especially targeted by social enterprises since individuals who meet these characteristics have been especially susceptible to current income inequality forces.[141]

In essence, there must be a determination of the individuals who

Critical Citizenship: Professors at a Crossroads, 22 U. FLA. J.L. & PUB. POL'Y 335, 342 (2011).

135. The term "poverty" will be defined as "those individuals whose household incomes are insufficient to provide essentials, such as clothing, food, and shelter, to the average person."

136. The "middle class" will be broadly defined as anyone who has achieved certain endeavors such as owning their own home, having savings for retirement, and having the ability to send their children to college.

137. Bernadette Rabuy & Daniel Kopf, *Prisons of Poverty: Uncovering the pre-incarceration incomes of the imprisoned* (July 9, 2015), http://www.prisonpolicy.org/reports/income.html.

138. Jason Breslow, *By the Numbers: Dropping Out of High School*, FRONTLINE (Sept. 21, 2012), http://www.pbs.org/wgbh/frontline/article/by-the-numbers-dropping-out-of-high-school/.

139. Emily Badger, *The Relationship Between Single Mothers and Poverty is Not as Simple as it Seems* (Apr. 10, 2014), https://www.washingtonpost.com/news/wonk/wp/2014/04/10/the-relationship-between-single-mothers-and-poverty-is-not-as-simple-as-it-seems/.

140. GENE FALK, TEMPORARY ASSISTANCE FOR NEEDY FAMILIES (TANF): ELIGIBILITY AND BENEFIT AMOUNTS IN STATE TANF CASH ASSISTANCE PROGRAMS, CONGRESSIONAL RESEARCH SERVICE 3 (July 22, 2014), (explaining that most states only provide TANF benefits to very poor families living below the poverty line).

141. INEQUALITY BRIEFING, WHY INEQUALITY MATTERS FOR POVERTY 1 (Mar. 2002), http://www.odi.org/sites/odi.org.uk/files/odi-assets/publications-opinion-files/3876.pdf.

should be targeted for social mobilization. In addition, the constituent target group should be further analyzed to prioritize according to necessity and projected success. Lastly, there must be a determination of the type of social mobility approach the FPSE will utilize to achieve social mobility. Inevitably, the FPSE's chosen social mobility approach will have great influence on its target group and the manner in which it chooses to economically empower its employees. In this section we will discuss a number of social mobility approaches and provide explanations of how these approaches can affect the determination of the target group and the manner in which FPSEs choose to economically empower their employees.

1. Social Mobility Approaches

In discussing social mobility, the question often turns to how it can be achieved and what approach will yield the greatest results. Although there have been a wide variety of proposed solutions,[142] I have highlighted the following four approaches as the most pertinent to FPSEs because they utilize economic empowerment as a means to achieve social mobility.

a. Social Mobility Approach: Improving Marginalized Neighborhoods

The place-based intervention theory emphasizes community development and public policy approaches to improve low-income neighborhoods. As the wealth distribution gap has continued to widen over the last decades, scholars have become interested in

142. *See, e.g.*, Dawinder S. Sidhu, *Civic Education as an Instrument of Social Mobility*, 90 DENV. U. L. REV. 977 (2013) (regarding social mobility through improvements in education); Tomiko Brown-Nagin, *Rethinking Proxies for Disadvantage in Higher Education: A First Generation Student's Project*, U. CHI. LEGAL F. 433 (2014) (regarding social mobility through improved access to higher education); Deardorff & Kupenda, *supra* note 134 (regarding social mobility through challenging injustices in society and in governmental policies); Lucille A. Jewel, *A Progressive View of Class, Culture, and the Law*, 43 UNIV. MEMPHIS L. REV. 239 (2012) (regarding social mobility through affirmative action).

understanding how neighborhoods can impact the individuals who reside within them. For instance, some have found that "individuals who reside in neighborhoods with a high concentration of individuals living below the poverty level are less likely to climb the social ladder."[143] Proponents of the place-based intervention theory argue that individuals in marginalized communities should remain in their neighborhoods and work towards improving their living conditions. Special attention must be paid to the local education system in their community and the public policies that have rendered their neighborhood's conditions possible.

FPSEs looking to enable social mobility through place-based intervention will likely concentrate their approach on improving a specific community or a number of communities with similar needs. Job opportunities should be prioritized for individuals from the target community. In addition, FPSEs can allocate some of their profits to aid the target community by investing in social projects within the area, funding lobbying efforts, and funding additional education resources for local school districts.

b. Social Mobility Approach: Mobilizing Individuals Into Affluent Neighborhoods

The residential mobility theory also recognizes the importance of the area in which individuals reside. However, the residential mobility theory uses a people-based approach and argues that people should be moved out of low-income neighborhoods and into more affluent communities.[144] The belief is that moving families to more

143. SHARKEY, *supra* note 31, at 35–36.

144. *See generally* RAJ CHETTY, NATHANIEL HENDREN, & LAWRENCE F. KATZ, THE EFFECTS OF EXPOSURE TO BETTER NEIGHBORHOODS ON CHILDREN: NEW EVIDENCE FROM THE MOVING TO OPPORTUNITY EXPERIMENT, NAT'L BUREAU OF ECON. RES., (May 2015). This approach has been explored by the United States Department of Housing and Urban Development (HUD) in the last two decades through its Section 8 voucher program. The goal of the program has been to relocate families from low-income housing communities and place them into residential neighborhoods within more affluent areas. In addition to HUD's Section 8 voucher program, a number of states have established Fair Share Housing Programs that provide grants to individuals

resourced communities will enable them to access resources that are simply not available to them in similarly under-resourced communities. Proponents maintain that this approach is especially beneficial to families with children because childhood access to resources, such as a high-quality education, are an important factor in successful upward mobility.[145] In addition, research has found that children who moved before the age of thirteen to affluent neighborhoods went on to earn thirty percent more in adulthood than children who had remained in low socioeconomic communities.[146] The overarching argument is that moving low-income families into affluent communities will provide their children access to additional resources and those additional resources will provide low-income individuals better access to the economy.[147]

FPSEs that wish to use residential mobility as their goal should target marginalized families with young children. FPSEs can enable residential mobility in a variety of ways. One simple method of enabling residential mobility is to provide employees with a salary that will allow them to afford housing in an affluent community. In addition, FPSEs can acquire residential housing in affluent neighborhoods and rent directly to their employees.

c. Social Mobility Approach: Providing Access to Additional Resources

The Access to Additional Resources Theory (AART) is based on the premise that both living in a low-income neighborhood and not having sufficient income, congruently, will dramatically impact the amount of resources individuals can access. For instance, individuals who reside in low-income communities may be afforded the

who want to build or refurbish affordable housing options within affluent communities.

145. Raj Chetty, Keynote Address at the Brookings Institute Center on Children and Families: Place, Opportunity, and Social Mobility: What Now for Policy? (June 1, 2015).

146. Chetty, *supra* note 145.

147. *Id.*

opportunity to access resources not available in their area if they have enough income to fund their commute to areas where these resources are available. In contrast to residential mobility theory and place-based intervention theory, AART simply aims to provide individuals with enough economic empowerment to afford them the opportunity to access additional resources. AART does not aim to directly improve communities or to relocate individuals, instead AART allows individuals to have the opportunity to obtain additional resources. For instance, FPSEs can provide sufficient income to ensure that employees can afford to provide their children with access to better performing schools.[148] In essence, AART empowers individuals to make their own decisions as to how and if they wish to change their social condition.

FPSEs that aim to adapt AART as their goal can take a direct financial empowerment approach. These financial strategies can come in the form of above living wages, employee incentive plans, bonuses, company equity, scholarships, and grants, amongst others.

d. Social Mobility Approach: Direct Economic Empowerment

The Direct Economic Empowerment Approach (DEEA) argues that the goal should be to provide enough income to enable social mobility.[149] Unlike the previous theories, DEEA has a clearly stated goal of directly providing to the targeted recipients benefits with monetary value. In accordance with our definition of social mobility, the provided income should enable employees to own their own home, have savings for retirement, and have the ability to send their children to college. This approach eliminates the need for third-party processes and is the approach that best allows FPSE to ensure social mobility. Economic empowerment can come in the form of above living wages, employee incentive plans, bonuses, and company

148. Compensation could perhaps be sufficient to cover transportation costs or to enroll in better performing private schools.

149. *See supra* Section III.B. Social mobility is defined above, as "economically mobilizing individuals living in poverty into the middle class."

equity, among others.

IV. The Creation of The Fourth Sector

The creation of the FPSE sector is a viable notion as seen by the bipartisan support of the enactment of new hybrid entities in several states.[150] New hybrid entity structures have received overwhelming support by members on both sides of the political spectrum.[151] In fact, in voting for the creation of the Benefit Corporation across seven states, the vote count was an overwhelming 892 positive votes to eighty-two nays.[152] Moreover, as of now, hybrid entities such as the L3C,[153] Flexible Purpose Corporation,[154] Benefit Corporation,[155] Benefit Limited Liability Company,[156] Social Purpose Corporation,[157] and the Minnesota Community Enhancement Corporation[158] have either been enacted or have been proposed as new law in recent years. On the one hand, Republicans appreciate that FPSEs use the market, and not

150. Kyle Westaway, *Something Republicans and Democrats Can Agree On: Social Entrepreneurship*, STAN. SOC. INNOVATION REV. (Apr. 17, 2012), http://ssir.org/articles/entry/something_republicans_and_democrats_can_agree_on_social_entrepreneurship.

151. Westaway, *supra* note 150.

152. *Id.*

153. There are currently eight states and two Native American Nations that have adopted some form of the L3C entity and there are 1,326 entities that have formed as an L3C throughout all jurisdictions. *See* INTERSECTOR PARTNERS, L3C, http://www.intersectorl3c.com/l3c_tally.html (last visited Mar. 18, 2016).

154. Flexible Purpose Corporation was created by S.R. 201 (Cal. 2011) but was later replaced by the Special Purpose Corporation. *See* CAL. CORP. CODE § 2600 (2016).

155. There are currently thirty-one states that have enacted Benefit Corporation statutes and five other that are considering legislation. *See* STATE BY STATE STATUS OF LEGISLATION, http://benefitcorp.net/policymakers/state-by-state-status (last visited Mar. 18, 2016).

156. The Benefit LLC was created by S.R. 595 (Md. 2011) (http://mlis.state.md.us/2011rs/billfile/sb0595.htm).

157. *See Goodbye Flexible Purpose Corporation, Hello Social Purpose Corporation*, LEX MUNDI PRO BONO FOUND., http://www.lawforchange.org/NewsBot.asp?MODE=VIEW&ID=6384 (last visited Mar. 18, 2016).

158. The Minnesota Community Enhancement Corporation was proposed by H.R. 697 (Minn. 2011) (https://www.revisor.mn.gov/bills/text.php?number=HF0697&version=latest&session=87&session_number=0&session_year=2011).

government money, as a solution to social issues.[159] On the other side, Democrats have been enamored by the idea that a business can be socially responsible.[160] Finally, both sides love the fact that FPSEs create jobs.[161]

These hybrid entities were created to provide a solution for those who looked to resolve social issues through the use of for-profit business activity funding.[162] Prior to the creation of these hybrid entities, it was difficult for executives of for-profit businesses to commit to social missions without violating their profit maximization duties.[163] In addition, these hybrid entities give individuals a legal entity through which they can combine inherent principles of both the private and nonprofit sectors.[164] From the private sector, FPSEs aim to use the market to create profits from the sale of services and goods.[165] In other words, the revenue that will fund the FPSE's purpose will derive from business operations and not donations.[166] From the nonprofit sector, FPSEs acquired a social purpose.[167] Moreover, like nonprofits, FPSEs understand that their social goal is not only their main priority but also their purpose for existing. In addition, hybrid entities allow social entrepreneurs to be freed from the draconian nonprofit regulatory restraints.[168] Although the creation of hybrid entities has enabled social entrepreneurs to more freely pursue their social mission endeavors, the creation of hybrid entities also created regulatory voids.[169] These voids must be addressed to ensure that FPSEs are working efficiently to propel their

159. Westaway, *supra* note 150.

160. *Id.*

161. *Id.*

162. Alicia E. Plerhoples, *Social Enterprise as Commitment: A Roadmap*, 48 WASH. U. J.L. & POL'Y 89, 89–90 (2015).

163. MARC J. LANE, SOCIAL ENTERPRISE: EMPOWERING MISSION-DRIVEN ENTREPRENEURS 11 (2011).

164. Plerhoples, *supra* note 162, at 91.

165. LANE, *supra* note 163, at 5.

166. *Id.*

167. *Id.*

168. Plerhoples, *supra* 162, at 90.

169. *Id.* at 91.

social missions.

These hybrid entities do not have the accountability mechanisms of private and nonprofit entities.[170] To begin with, hybrid entities lack the private sector's primary duty of maximizing profits for shareholders.[171] Without the private sector's main accountability mechanism, hybrid entities are vulnerable to self-benefit, inefficiency, waste, and overall mismanagement.[172] Additionally, hybrid entities are not accountable to the nonprofit sector's standards of private inurement and private benefit, which prohibit the disbursement of the entity's earnings to insiders and require that the entity be created and maintained to serve the public's interest, respectively.[173] Consequently, FPSEs are currently regulated by the perceived good will of social entrepreneurs.[174] In other words, FPSEs are currently operating without optimal regulatory standards and oversight.

A. FPSE Regulation and Oversight

Public policy should ultimately be aimed at formally creating, growing, and maintaining the FPSE sector. However, public policy should initially aim to solidify regulatory schemes and establish proper oversight mechanisms. Once proper regulations and oversight are in place, public officials will be confident that FPSEs are efficiently operating to serve a social purpose and public policy enacted to enable the growth of the FPSE sector will likely follow.

1. Solidifying the FPSE Regulatory Scheme

Although there are a number of different hybrid entities with their own respective regulatory schemes, current entities would better attract social entrepreneurs and social investors by including a number of regulatory additions and adjustments. Just like in the

170. Plerhoples, *supra* 162, at 91.
171. *Id.*
172. *Id.*
173. *Id.*
174. *Id.* at 92.

nonprofit sector,[175] FPSEs should be mandated to include certain provisions in their governance documents. First, governance documents should include language that explicitly states the FPSE's social mission in detail, its business strategy, and an explanation of how the business strategy and the social mission intermingle. Second, governance documents should also include language that calls for a supermajority vote for any amendments to the social mission or the business plan.[176] Third, governance documents should state that the FPSE will, at least, provide "living wages"[177] to its subordinate employees and that wages will increase at the same rate as the cost of living. Finally, governance documents should provide employee-voting rights for issues pertaining to working conditions and compensatory schemes.

In addition to mandatory language on governance documents, regulations should designate the creation of a simplified annual financial report, which explains how the business plan and the revenue are being used to propel the FPSE's social mission.[178] Annual

175. CAL. CORP. CODE §§ 5150–53 (2016).

176. This is unlike most current L3C statutes, which allow for the entity to automatically turn into a regular LLC if the entity decides to no longer pursue its social purpose. Dana Thompson, *L3Cs: An Innovative Choice For Urban Entrepreneurs and Urban Revitalization*, 2 AM. U. BUS. L. REV. 115, 143 (2012).

177. Living wages should be set by the FPSE oversight agency.

178. Currently most Benefit Corporation statutes call for annual or biannual reports, which describe the progress of the entity in meeting their social and financial objectives. In addition, Benefit Corporations must provide an assessment of their pursuit of a public benefit against a third-party standard. Joseph W. Yockey, *Does Social Enterprise Law Matter?*, 66 ALA. L. REV. 767, 783 (2014). In addition, the Social Purpose Corporation Statute calls for the creation of an annual report that includes financial statements and a Management Discussion and Analysis ("MD&A") where there is a discussion about the special purpose objectives as well as the actions taken and the expenses incurred to achieve those special purpose objectives. Also, the Social Purpose Corporation must send a special purpose current report to the shareholders within forty-five days when the Social Purpose Corporation (1) makes any expenditure of corporate resources in furtherance of the special purpose objectives, (2) withholds any expenditures in furtherance of the special purpose, or (3) determines that the special purpose has been satisfied or should no longer be pursued. All reports must be made available on the entities' websites and upon request. Reports must be written in plain English. Jeremy Chen, *What is a California*

reports should include the ratio of CEO hourly wages compared to that of the average hourly wage of the lowest thirty percent of paid employees.[179] Annual reports should be created in accordance with standards set forth by the later discussed FPSE Agency.[180] Regulations should also include enforcement procedures in the form of pseudo derivative suits that can be brought by stakeholders, shareholders, and the FPSE Oversight Agency.[181] Enforcement procedures should include the possibility of consequential "claw backs"[182] and criminal consequences for those who are found to be in purposeful violation of FPSE regulations. Finally, regulations should state that the FPSE would cease to exist if the entity will no longer pursue the same or a similar social mission. In such instance, the FPSE Agency should be mandated to ensure the prompt distribution of remaining funds to debt and shareholders. Ultimately, these regulations would ensure that FPSE executives are, at the very least, propelling their respective social missions, economically empowering their employees, and are held responsible if they purposely stray from FPSE regulations. In addition, these proposed regulations would ensure that social investor money is being used for stated social

Social Purpose Corporation?, http://jeremychenlaw.com/what-is-a-california-social-purpose-corporation/ (last visited Mar. 18, 2016).

179. This is similar to section 953(b) of the Dodd-Frank Act, which requires that companies disclose: (1) the median annual total compensation of all its employees, except the CEO; (2) the annual total compensation of its CEO; and (3) the ratio of those two amounts.

180. Yockey, *supra* note 178. Currently Benefit Corporations must provide an assessment of their pursuit of public benefit through the use of a third party standard. Third party standards could be the standards used by B-Lab or SASB standards.

181. *Id.* at 783–84. Currently, Benefit Corporation regulations include an enforcement proceeding which gives shareholders, directors, and beneficiaries the right to bring an action against directors if they believe the director is acting in a manner that does not align with the entity's governance documents.

182. Similar to the "clawback" provisions in the Sarbanes-Oxley and Dodd Frank acts, section 304 of the Sarbanes-Oxley Act requires that CEOs and CFOs reimburse issuers for bonuses and profits on the sale of the issuer's shares over the preceding twelve months if the issuer restates its financial statements due to misconduct. Section 954 of the Dodd-Frank Act of 2010 requires companies to establish policies to recover incentive-based pay of any current or former executives awarded over the three years prior to a restatement, regardless of whether there was misconduct.

purposes and that the funds will be returned if an entity chooses to forgo its social mission endeavors.

2. FPSE Oversight Agency

The Securities Exchange Commission, U.S. State Department, Internal Revenue Service (IRS), Secretary of State, and Federal Trade Commission, ensure that the private and nonprofit sectors are in compliance with their respective regulations. Similarly, the FPSE sector should have an oversight agency ("Agency") to ensure proper operations within the FPSE sector and relieve the IRS of any FPSE duties.[183] Although, B Lab[184] currently offers "B Corp Certifications" to for-profit entities that meet their governance language requirements, "B Corp Certifications" have no legal significance.[185] Moreover, "B Corp Certifications" are mostly useful in terms of informing the educated public about products and services that are honestly offered in pursuit of a social purpose. While this a great consumer protection endeavor, it falls short of providing official government oversight. The FPSE sector Agency should be responsible for ensuring that all regulatory language is included in governance documents, creating and maintaining a "whistleblower" system, receiving and auditing annual financial reports, investigating FPSEs in case of suspected malfeasance, extinguishing fraudulent entities, ensuring that funds from extinguished entities are properly distributed to debt and shareholders, and reporting criminal violations to proper authorities. In addition, the Agency should take over the IRS's duties that are pertinent to FPSEs.[186] Ultimately, the FPSE sector Agency would ensure that all pertinent regulations are

183. Manoj Viswanathan, *Form 1023-EZ and the Streamlined Process for the Federal Income Tax Exemption: Is the IRS Slashing Red Tape or Opening Pandora's Box?*, 163 U. PA. L. REV. 89, 93 (2014) (arguing that due to recent budget cuts to the already over-worked and underfunded Tax-Exempt and Government Entities Unit of the IRS ("the Unit"), the Unit has been further limited in its ability to adequately perform its duties).

184. LANE, *supra* note 163, at 12.

185. *Id.*

186. For example, determining PRI eligibility for FPSEs.

being met and that FPSEs are efficiently and honestly utilizing their funding to propel their social missions. Once elected officials are confident that FPSEs are properly regulated and have oversight, they can use public policy to both enable the growth of the FPSE sector and create a higher incentive for investment in the FPSE sector by individuals.

B. Enabling the Creation and Growth of the FPSE Sector Through Public Policy

In attempting to enable the creation, maintenance, and growth of the FPSE sector, successful public policy must aim at incentivizing Social Entrepreneurs, facilitating the sustainability and growth of social enterprises, and incentivizing social investors. This three-prong approach will make it more likely that social entrepreneurs will choose to create and maintain FPSEs and that social investors provide sufficient funding for the creation and maintenance of FPSEs. Moreover, it is likely that without a substantial response to any of the three prongs, the FPSE sector will fail to amount enough momentum to create a significant amount of social mobilization.

1. Incentivizing Social Entrepreneurs

FPSE public policy should incentivize individuals to create and manage FPSEs. Potential social entrepreneurs might be apprehensive about starting a FPSE because of the risk of low earnings. This apprehension can be addressed by enacting public policy that will counterbalance the potential for lower earnings. Although this issue can be resolved through the use of a number of government spending programs, tax expenditures[187] will likely be the best solution. As such, FPSE public policy can successfully incentivize social

187. Tax expenditures are "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." *See* Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, § 3(3) (1974).

entrepreneurship via tax expenditures aimed at lowering the tax liability of wages paid to executives and owners by FPSEs. For instance, public policy can include preferred tax rates from the wages and profit sharing earnings from FPSE revenue. Currently, the individual tax rate for individuals is 39.6 percent.[188] Therefore, tax rates on earnings and wages from FPSEs should be less than current tax rates on similar earnings but positioned strategically to incentivize but not cause an unnecessary loss of revenue for the government. Nevertheless, regardless of the chosen initiative, public policy should be comprehensive and should attempt to holistically resolve apprehensions caused by the potential for low earnings.

2. Enabling the Maintenance and Growth of For-Profit Social Enterprises

In attempting to enable the creation, maintenance, and growth of the FPSE sector, public policy should aim to alleviate the FPSE's burden of securing funding. In addition to the creation of FPSE investment vehicles, public policy should attempt to facilitate the obtainment of foundation funds and bank loans by FPSEs in the following ways:

(1) Loan Guarantees: Loan guarantees are loans that are secured by a third party. By issuing loan guarantees instead of providing funding, guarantors can more efficiently utilize their coffers as collateral.[189] As a result, guarantors are able to secure larger and more secure amounts of funding for FPSEs.[190] For instance, using Loan Guarantees, a charter school in Houston was able to obtain

188. I.R.S., Employer's Tax Guide 2016, https://www.irs.gov/pub/irs-pdf/p15.pdf (Dec. 23, 2015).

189. Antony Bugg-Levine, Bruce Kogut & Nalin Kulatilaka, *A New Approach to Funding Social Enterprises: Unbundling Societal Benefits and Financial Returns Can Dramatically Increase Investment*, HARV. BUS. REV. 5 (2012), https://hbr.org/2012/01/a-new-approach-to-funding-social-enterprises.

190. *Id.*

$67 million in funding.[191] Because the loan was guaranteed by donors who were able to qualify for low rates, the school and the donors saved almost $10 million in interest payments.[192]

(2) Treasury Regulation on Program Related Investments (PRIs): A PRI is a modest rate loan provided by a private foundation to qualifying FPSEs.[193] Private foundations are 501(c)(3) tax-exempt entities that primarily attempt to accomplish their social purposes through the use of grants or PRIs.[194] Private foundations are required to distribute at least five percent of their net value every year or else they will be taxed on their remaining value.[195] However, many private foundations are apprehensive about distributing funds in the form of PRIs because they are prohibited from making jeopardizing investments.[196] The Treasury Department has made clear that PRIs are not jeopardizing investments.[197] However the definition of a PRI as set forth by the Treasury Department's regulation is narrow and seems to ascertain that investments in FPSEs are prohibited.[198] In particular, the prong which states that "no significant purpose of the investment is the production of income or the appreciation of property" is a

191. Bugg-Levine et al., *supra* note 189.

192. *Id.*

193. Westaway, *supra* note 150.

194. Thompson, *supra* note 176, at 146.

195. 26 U.S.C. § 4942 (2015).

196. 26 U.S.C. § 4944(a)(1) (2015).

197. 26 C.F.R. § 53.4944-3(a)(1) (2016).

198. "A PRI is an investment made by a private foundation to a nonprofit or for-profit entity that complies with the three following requirements: (1) the primary purpose of the investment is to accomplish one or more charitable, educational, religious or other exempt purposes under Section 170(c)(2)(B) of the IRC; (2) no significant purpose of the investment is the production of income or the appreciation of property; and (3) no purpose of the investment is to lobby, support or oppose candidates for public office, or to accomplish any other political purposes forbidden to private foundations by Section 170(c)(2)(D) of the IRC." 26 C.F.R. § 53.4944-3(a)(1)(i)–(iii).

barrier to foundations that are afraid that their PRI to a FPSE will be deemed a jeopardizing investment because it has a significant potential of creating income for the foundation. Although the Treasury regulations provide specific examples that delineate that providing PRIs to FPSEs in urban locations are not jeopardizing investments, the Treasury Department should aim to better clarify and broaden its regulation.[199] This can be done by amending the Treasury Department regulations to explicitly state that PRIs made to FPSEs in good standing with the FPSE Agency will not be deemed as jeopardizing investments, and will be taken into consideration when calculating the foundation's distribution amount at the end of the year.

(3) Program Related Investment Eligibility Determinations: Under the existing policy, the loan provider is responsible for obtaining a ruling from the IRS, certifying that the FPSE has met the criteria to be eligible to receive the PRI.[200] This process has resulted in the substantial limitation of PRI funding to FPSEs.[201] Public policy should aim to facilitate the receipt of PRI eligibility confirmation in the following three ways: First, the FPSE Agency should be responsible for PRI eligibility determinations. This would streamline the process by easing the burden of determination from the IRS, which is inundated with an abundance of other matters.[202] Second, FPSEs should be able to request and receive their own PRI eligibility determinations, instead of having to rely on the private foundation. Lastly, PRI eligibility determinations should be valid for at least 6 months and should be accepted by all private foundations for all PRI funding determinations during that time period. This would alleviate the FPSE's need to acquire a PRI eligibility determination every time it is seeking

199. Thompson, *supra* note 176, at 148.
200. *Id.*
201. *Id.*
202. Viswanathan, *supra* note 183.

funding from a private foundation.

In addition to facilitating the procurement of loans, public policy should ensure that FPSEs are allowed to keep a sufficient amount of their generated revenue. Since FPSEs will utilize a large amount of their revenues to support their operations and social mission, FPSEs would greatly benefit from a lowered tax liability. Public policy to lower the tax liability of FPSEs can come in the form of tax expenditures. For instance, public policy can provide for a lower corporate tax rate for revenue produced by FPSEs. Currently, corporate tax rates are capped at thirty-five percent.[203] Therefore, in order to offset the potential costs of operations and higher employee compensation, FPSE corporate tax rates should be less than current tax rates and strategically positioned to mitigate the higher costs of employee compensation and operations of FPSEs. In addition, a tax expenditure can come in the form of a deduction or a credit for the costs of complying with regulatory reporting mandates or other costs incurred in relation to adhering to FPSE regulations.

Finally, public policy must ensure that the government becomes a direct ally to the FPSE sector. Previously proposed public policy encouraged the federal government to utilize the goods and services of FPSEs.[204] While this proposed piece of legislation aims at informing the federal government of the existence of FPSEs, this proposed public policy does not go far enough. Instead, public policy would be more efficiently deployed if it mandated that the federal government employ the services of FPSEs when the costs of using the good or service are not higher than similarly positioned competitors. As a result, FPSEs would obtain a greater amount of government contracts, which would help produce revenue that would be used to maintain and grow the operations of FPSEs.

3. Incentivizing Social Investment

Perhaps the greatest and most important task will be to create

203. *See* DELOITTE, CORPORATE TAX RATES 2015 (Aug. 2015), https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-corporate-tax-rates-2015.pdf.

204. Westaway, *supra* note 150.

enticing investment opportunities for social investors. Although different sources provide that United States social investment funds total $50 billion, $600 billion, $1 trillion, and $6.57 trillion, these figures demonstrate that there is a viable funding source for FPSEs. However, only a portion of this money is being acquired by FPSEs because there is a lack of FPSE investment opportunities. In fact, one source estimates that only about eight percent of total social investment money was used each year.[205] In order to enable the growth of the FPSE sector with the funding from private investors, it is important that enacted public policy attempt to mainstream FPSE investment opportunities. Further, public policy should promote the following investment vehicles to facilitate investment in FPSEs and create attractive investment opportunities:

(1) Social Investment Bonds (SIBs): These are bonds that are purchased by private investors to fund the missions of FPSEs.[206] The bonds are later repaid by the government if the project is deemed successful under specific metrics.[207] These metrics will likely include a dual mission: 1) alleviate a social issue and 2) save the government money.[208] In addition, if the social program is especially successful, the private investor will receive an additional amount of money on top of their original funding.[209] SIBs are appealing to investors because it allows them to take calculated risks in pursuit of profit.[210] In addition, SIBs are beneficial to the government because they place the risk on the private investor and the government only pays if the project is successful.[211] We have already seen a successful SIB initiative in Massachusetts, where private investors

205. Bugg-Levine et al., *supra* note 189, at 7.

206. Bhagwan Chowdhry, Shaun W. Davies & Brian Waters, *Incentivizing Impact Investing* 1 (Aug. 25, 2015), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2437238.

207. Bugg-Levine et al., *supra* note 189, at 6.

208. Chowdhry et al., *supra* note 206.

209. *Id.*

210. Bugg-Levine et al., *supra* note 189, at 6.

211. Chowdry et al., *supra* note 206.

invested $12 million to provide employment training for at-risk young men.[212] The state will have to repay the bonds if in five years the program reduces re-incarceration rates by forty percent.[213]

(2) Social Impact Guarantees (SIGs): Like SIBs, SIGs use private investment money to fund social projects.[214] However, in contrast to SIBs, the funding must be repaid if the project fails to reach specified goals.[215] In other words, the investor will reward the party responsible for repayment by forgiving the repayment or reducing the amount owed if they obtain certain results.[216]

(3) Quasi-Equity Debt (QED): QED has principles of both equity and debt securities.[217] It is, for all intents and purposes, a debt; however, its returns are based on the entity's financial performance.[218] Although the investor has no voting rights, the conditions of the debt are methodically designed to incentivize the efficient and profitable operation of the entity.[219]

With the enactment of public policy that will create these and other FPSE investment vehicles, investors will have additional avenues to pursue, which promise to provide low, but safe, returns.[220] As a result, investors are likely to more often include FPSE investment in their portfolios.[221] Investors and the financial markets stand to gain from the creation of these FPSE investment vehicles, as they will be able to obtain additional returns from new kinds of services and goods.[222]

212. Chowdry et al., *supra* note 206.
213. *Id.*
214. *Id.*
215. *Id.*
216. *Id.*
217. Bugg-Levine et al., *supra* note 189, at 5.
218. *Id.*
219. *Id.*
220. *Id.* at 6.
221. *Id.*
222. *Id.*

In addition to the creation of social investment vehicles, public policy can also use tax expenditures as a means of incentivizing social investment. For instance, FPSE public policy can create special tax rates for returns from FPSE investments. Public policy can call for FPSE tax credits, FPSE deductions, and partial exclusions. Ultimately, public policy must not only aim to facilitate investment by current social investors but must also attempt to convert new social investors. The FPSE sector will need the support of a mass coalition of private investors if it is to thrive and create a significant amount of social mobility.

Conclusion

This Note has argued that, either through failure or deliberate action, the three existing sectors of the American market have enabled the creation of record-high income inequality rates. Moreover, these synthetically created high rates of income inequality have led to low rates of social mobility, which have been especially troublesome for marginalized communities. Consequently, a fourth sector is needed in order to directly alleviate this lack of social mobility. In addition to expanding and solidifying the current regulatory schemes for FPSE entities, public policy should aim at incentivizing entrepreneurs, maintaining and growing the FPSE sector, and incentivizing social investing. Ultimately, with the help of public policy and access to proper funding from private social investors, the FPSE sector has the potential of creating significant social mobilization amongst those who are most vulnerable to current market conditions.