

CEBRIG Working Paper



Solvay Brussels School
Economics & Management

Crowding-In or Crowding-Out? How Subsidies Signal the Path to Financial Independence of Social Enterprises

Patrick Reichert, Marek Hudon, Ariane Szafarz, Robert
K. Christensen

In today's multisector configurations, there is little clarity about whether and how public and private subsidies influence social enterprises' pursuit of financial stability. We address the strategic role of donors in the social-business life cycle whereby social enterprise start-ups rely on subsidies, while mature social enterprises strive for independence from donors. To address the "missing middle," we develop a typology of subsidy instruments and an intermediary signaling model to clarify how subsidies shape the evolution of outcomes for social enterprises. We argue that source variation matters for certain instruments like corporate intangibles and governmentally subsidized credit guarantees, which trigger crowding-in effects and attract commercial partners, while preventing perverse crowding-out effects, such as soft budget constraints. To illustrate this commercialization story, we draw upon a microfinance case study, demonstrating how public and private donors can induce crowding-in and crowding-out effects. In short, our subsidy typology helps unpack the signals that public and private subsidies send to commercial funders of social enterprises and how they shape the path to future financial independence.

Keywords subsidy, crowding-in, crowding-out, signaling theory, resource acquisition, social finance.

JEL Classifications H83, G23, H81, M16, M14, G21.

CEBRIG Working Paper N°21-014
August 2021

Université Libre de Bruxelles - Solvay Brussels School of Economics and Management
Centre Emile Bernheim de Recherche Interdisciplinaire en Gestion
ULB CP114/03 50, avenue F.D. Roosevelt 1050 Brussels BELGIUM
cebrig@ulb.be - Tel : +32 (0)2/650.48.64

The logo for the Université Libre de Bruxelles (ULB), consisting of the letters 'ULB' in white on a blue square background.

Crowding-In or Crowding-Out? How Subsidies Signal the Path to Financial Independence of Social Enterprises

Patrick Reichert

Université Libre de Bruxelles (ULB), SBS-EM, CEB, and CERMi
Avenue F. Roosevelt, 50 Brussels, Belgium 1050
Phone: +32 02 650 22 30
preicher@ulb.ac.be

Geneva Center for Social Innovation, IMD
Chemin de Bellerive, 23 Lausanne, Switzerland 1001
Phone : +41 21 618 08 54
Patrick.reichert@imd.org

Marek Hudon

Université Libre de Bruxelles (ULB), SBS-EM, CEB, and CERMi
Avenue F. Roosevelt, 50 Brussels, Belgium 1050
Phone: +32 02 650 42 47
mhudon@ulb.ac.be

Ariane Szafarz

Université Libre de Bruxelles (ULB), SBS-EM, CEB, and CERMi
Avenue F. Roosevelt, 50 Brussels, Belgium 1050
Phone: +32 02 650 48 65
aszafarz@ulb.ac.be

Robert K. Christensen

Brigham Young University, Marriott School
771 TNRB, Provo, UT USA 84602
Phone: +1 801 422 6414
rc@byu.edu

* This work was supported by an Interuniversity Attraction Pole funded by the Belgian Science Policy Office under the title “If Not for Profit, for What and How?” We are grateful to Marc Jegers, Valentina Hartarska, Marc Labie, and Tyler Wry for their helpful comments and suggestions on this and earlier drafts of the article, as well as the participants of the 6th EMES Research Conference on Social Enterprise, 5th European Research Conference on Microfinance, 3rd VUB-ULB Doctoral Workshop, and 15th Edition of the ULB-Sorbonne Research Day.

Crowding-In or Crowding-Out? How Subsidies Signal the Path to Financial Independence of Social Enterprises

Abstract

In today's multisector configurations, there is little clarity about whether and how public and private subsidies influence social enterprises' pursuit of financial stability. We address the strategic role of donors in the social-business life cycle whereby social enterprise start-ups rely on subsidies, while mature social enterprises strive for independence from donors. To address the "missing middle," we develop a typology of subsidy instruments and an intermediary signaling model to clarify how subsidies shape the evolution of outcomes for social enterprises. We argue that source variation matters for certain instruments like corporate intangibles and governmentally subsidized credit guarantees, which trigger crowding-in effects and attract commercial partners, while preventing perverse crowding-out effects, such as soft budget constraints. To illustrate this commercialization story, we draw upon a microfinance case study, demonstrating how public and private donors can induce crowding-in and crowding-out effects. In short, our subsidy typology helps unpack the signals that public and private subsidies send to commercial funders of social enterprises and how they shape the path to future financial independence.

Keywords: subsidy, crowding-in, crowding-out, signaling theory, resource acquisition, social finance

Introduction

Social enterprises are hybrid organizations that use public and private resources and commercial operations to address social and environmental issues (Santos, Pache, and Birkholz 2015). Social enterprises play an increasingly important role in contemporary public and nonprofit administration (Kerlin, 2009; Hayllar and Wettenhall, 2013; Salamon, 2015; Tekula and Andersen, 2019). As such, Choi, Berry and Ghadimi (2020) recently invited “public administration and policy scholars ... to accumulate both theoretical and practical knowledge on how governments shape social enterprises” (502). In engaging this invitation our aim is to extend theoretical knowledge, illustrated with a practical case, Bancos Compartamos, to conceptually clarify how public and private subsidies shape the financial stability of social enterprises.

Like other entrepreneurial ventures, the acquisition of resources is a key challenge for social enterprises since they lack experience and proven competencies (Zott and Huy 2007). The double bottom line of social enterprises also makes them more opaque to outsiders than traditional start-ups, and thus more likely to resolve information asymmetries through soft information to attract funding (Cornée 2019). Nevertheless, the pursuit of both financial and social value creation appeals to public and private donors who increasingly seek to leverage their limited resources and crowd-in commercial private investment to scale projects that serve the public good (Agranoff and McGuire 2001; Di Domenico, Haugh, and Tracey 2010; Smith, Cronley, and Barr 2012).

Scaling has long been recognized as a core concept for social enterprises (Dees, Anderson, and Wei-Skillern 2004; Schneider 2017). Scaling impact is key to evaluate the performance of social enterprises (Ebrahim and Rangan 2014; Molecke and Pinkse

2017). To date, scholars have investigated the strategies and processes to scale impact (e.g., Dees, Anderson, and Wei-Skillern 2004; Hartley and Benington 2006; Ni and Zhan 2017; Dobson et al. 2018), the drivers of scaling impact (e.g., Bacq and Eddleston 2018; Bloom and Chatterji 2009), and the ethical and organizational challenges of scaling impact (e.g., André and Pache 2016; Bradach 2003). However, the literature is relatively silent on scaling impact from a corporate finance perspective.

This gap is problematic since the promise of social entrepreneurship centers in the ability to achieve financial sustainability and operate independent of government and philanthropic support (Di Domenico, Haugh, and Tracey 2010). To date, commercial finance has been unable (or unwilling) to provide the quantity of or, perhaps more importantly, the *appropriate* mix of resources to meet the demand of this growing sector (Lall, Chen, and Davidson 2019; Lall, Chen and Roberts 2020). This paradigm leads to a business life cycle where social start-ups rely on public and private donors, while mature social enterprises strive for independence from donors. This paper addresses the “missing middle,” i.e., the transitional path leading from subsidy-taking endeavors to commercial enterprises. We seek to understand how public and private subsidies frame the transition and help social enterprises scale up and attract sustainable commercial resources for maximum social impact (Terjesen, Bosma, and Stam 2016). We argue that central transitional features are conditioned by subsidy features such as source-sensitivity and time-sensitivity.

To support our case, we have developed a conceptual typology that identifies how some public and private subsidy instruments open access to commercialization while others make it more difficult. Although the term *commercialization* often invokes negative

connotations related to a nonprofit or public organization's abandonment of its social mission to pursue earned revenue, we use the term commercialization to refer to the sustainable integration into the mainstream business sector (Armendáriz and Morduch 2010). The negative connotation of commercialization, also known as "mission drift," can be viewed as a shift of hybrid organizations toward underweighting their social bottom line and typically targeting better-off clients (Mersland & Strøm, 2010; Armendariz & Szafarz, 2011). Mission drift is often associated with changes in legal status, remuneration scheme and governance features (Ramus and Vaccaro, 2017), stemming from a lower concern for altruism (Hudon et al., 2020; Cozarenco & Szafarz, 2020).

By contrast, this paper focuses on financial independence, a positive consequence of commercialization.¹ We show how subsidy instruments shape the path to self-sustainability for social enterprises. Our typology introduces preferential debt and preferential equity alongside the more recognizable subsidy instruments of grants and procurement. Preferential debt refers to concessionality along any dimension of debt financing (i.e., interest rate, grace period, security feature). Similarly, preferential equity refers to concessions on equity features (i.e., dividend cap, restricted voting rights, etc.).

To make the connection between subsidy instruments and financial stability, we construct a conceptual framework combining signaling theory and habit formation theory.

To date, signaling theory has been underutilized in the public and nonprofit administration and policy literatures. Further, the signaling literature has prioritized the recipient as the focal organization (Connelly et al. 2011; Vasudeva, Nachum and Say 2018;

¹ To some extent, mission drift and financial independence are opposite sides of the same coin since the consequences of the push by donors for social enterprises to become financially independent can trigger mission drift (Augsburg and Fouillet, 2013).

Lall and Park 2020). By contrast, we develop an intermediary signaling model to examine the signals that public and private donors send to commercial investors through the design of subsidy instruments. In doing so, we aim to increase our understanding of the factors that contribute to the achievement of public outcomes across different organizational contexts (Moulton 2009). As for habit formation theory, which has been developed by scholars in social psychology (Verplanken, 2018) and applied in several field connected to managerial aspects such as client loyalty and information systems (Liu-Thompkins and Tam 2013; Limayem et al. 2007). We extend the scope of this fruitful conceptualization to subsidy-dependent managerial habits that can counteract the commercial mindset.

We argue that both public and private donors, although they face different constraints in their provision of subsidy, can induce crowding-in and crowding-out effects on commercial capital. We suggest that crowding-in occurs via smart subsidies, which are rule bound, time limited and transparent (Morduch 2007). By contrast, crowding out occurs through what we call addictive subsidies, which are untargeted, sticky and opaque.

From a business life cycle perspective, smart grants serve as a crowding-in mechanism during the formative stages of a social enterprise, signaling commercial funders to the adoption of market logics within the organization. However, once a social enterprise has achieved break-even, further grant subsidies are likely to crowd-out commercial investors. Regarding source variation, we argue that in-kind grants provided by private donors send stronger signaling effects to commercial funders than in-kind grants provided by public donors.

Smart preferential debt helps the social enterprise transition from a loss-making organization to a profitable enterprise, which can crowd-in commercial investors by helping

the social enterprise demonstrate its commercial viability. However, the use of grace periods, a temporary delay in debt repayment, is likely to weaken crowd-in signals to commercial funders compared to subsidized interest rates or guarantees since grace periods allow social enterprises to forego financial discipline. Further, when preferential debt is delivered as a credit guarantee, subsidy providers explicitly crowd-in commercial capital, which is particularly attractive to public donors seeking to leverage their scarce capital base in the face of austerity. Preferential debt is also subject to time-sensitivity; its continued use alerts commercial investors to the poor efficiency of the social enterprise or its inability to commercialize at scale and thus serves as a crowding-out mechanism. Finally, smart preferential equity subsidies do not place limitations on the upside financial return potential of the social enterprise to commercial investors. Donors can facilitate crowding-in through equity positions by playing the role of a specialized investor that adds value during early stages of venture development (Schwienbacher 2013).

To illustrate the issues at stake, we apply our theory to the microfinance industry, where we focus on the subsidies to one of Latin America's largest microfinance organizations (MFOs): Banco Compartamos. Over the past several decades, microfinance has become a globally popular tool to reduce poverty, attracting large investments from both public and private funders (Battilana and Dorado 2010). The case of Compartamos, which culminates in an initial public offering (IPO) on the Mexican stock exchange in 2007, is one of the most significant events in microfinance. Although the case is one of extreme commercialization, it is useful to highlight the transition of a social enterprise from donative non-profit to a publicly listed firm. The Compartamos case provides empirical evidence of several subsidy instruments that public and private donors used to crowd-in

commercial, private capital and illustrates how subsidy design evolves throughout the business lifecycle, from an emphasis on grants early on to preferential debt and equity later in the organization's development.

The article is structured as follows. We first present a typology of public and private subsidy and subsequently articulate propositions about the crowding-in and crowding-out effects that public and private subsidies "signal" to commercial investors. We then apply our theory to the microfinance industry. We conclude with a discussion of the implications for subsidy design aiming to foster financial stability for social entrepreneurship.

Subsidy Instruments: A Brief Primer in Context

Subsidies are ubiquitous in modern market economies but often carry negative connotations as market distorting devices. Rebranding efforts are illustrated by the growth of new domains such as impact investing, venture philanthropy and blended finance, which employ subsidized instruments in efforts to scale the impact of social enterprises. Despite variation in the depiction of subsidy instruments, there has been little attempt to systematically understand the underlying mechanisms across these emergent empirical phenomena.

To this end, we transpose and extend the governmental subsidy typology of Schwarz and Clements (1999) to account for private sector donors, who are supplementing traditional charitable activities such as grant-making with an expansive toolbox of financial instruments including loans, guarantees, crowdfunding, social impact bonds and equity (Falck and Heblich 2007; Salamon 2014). Public and private donors in these domains provide a wide range of subsidy instruments, including grants (monetary and in-kind), loans, guarantees, quasi-equity, bonds, equity, and procurement arrangements (see figure 1). In the

following sections we will discuss four of the most common subsidy instruments: grants, procurement, preferential debt, and preferential equity.

[Figure 1 here]

Grants

Whether classified as a government grant (Breton 1965), a philanthropic gift, or an in-kind donation (Duncan 2004), all forms of grant support lack an ex-ante expectation of recoverability (Emerson 2003; Lall, Chen, and Davidson 2019). In financial terms, this implies a negative 100 percent rate of return for donors. Grants come in both monetary and nonmonetary (i.e., in-kind) forms. Table 1 highlights the generic features of monetary and in-kind grants. Unconditional cash grants may be referred to as “no-strings attached” grants or general operating support, but both public and private forms of unconditional grants distribute cash to be used at the full discretion of the recipient (Brest 2003). In comparison, conditional cash grants attach restrictions to their disbursement or limit expenditures on particular activities. The subsidy component for unconditional and conditional cash grants is transparent for donors and recipients because it is simply the transferred sum of cash (Morduch 2007).

[Table 1 here]

As an alternative to granting cash, donors may volunteer time or give tangible contributions. These nonmonetary grants are referred to as in-kind donations and are the

transfer of any other type of asset aside from cash (Ellwein et al. 1998). In-kind donations consist of either tangible or intangible support. Although in-kind grants are less transparent than monetary grants—donors and recipients may have different valuations of in-kind support—they are less easy to divert because grant recipients need ready access to secondary markets to liquidate tangible donations into cash.

Procurement

The World Trade Organization (WTO) defines public procurement subsidies as government purchases at administered prices such that “a mark-up over free-market prices is afforded to certain producers” (WTO 2006, p. 51). Governments can also establish price support schemes, in which the state agrees to purchase the surplus of a good at a minimum price. Procurement subsidies are often public-private partnerships that encourage collaboration among private firms, foundations, and governments. In these relationships, private and private donors collaborate to reduce information asymmetries in private markets.

In many contexts, procurement programs aim to serve social purposes, either by boosting the competitiveness of businesses that lack resources to compete in domestic or international markets or that incorporate a socially desirable component into their product or service (Jones 2011). For example, advanced market commitments (AMCs) aim to bridge the disconnect between demand for treatments for diseases such as HIV/AIDS, malaria, tuberculosis and other tropical diseases and the willingness of manufacturers to supply treatments at an affordable price (McGoey 2014). The idea of AMCs is fairly straightforward: a donor makes a legally binding commitment to purchase a particular amount of a vaccine or drug if that product is successfully developed and made available in

developing regions. If no treatment is produced, donor organizations are not liable to meet costs; if one is produced, manufacturers are guaranteed a financial reward (McGoey 2014).

Preferential Debt

In general, preferential debt—financial instruments that break the timing link between consumption and payment for a good or service—can be categorized into three dimensions: interest rate, grace period, and security features. Table 2 highlights these dimensions.

[Table 2 here]

Preferential treatment within one of these dimensions becomes an implicit subsidy or grant element because it can be estimated in cash terms and represents a cost (to the donor) and a benefit (to the recipient). Such obligations are often referred to as *soft loans* or *below-market debt* (Spiess-Knafl and Aschari-Lincoln, 2015); we use the term *preferential debt* to stress the privileged treatment given to the recipient.

In both developing and developed countries, credit guarantee programs have become widely adopted as a largely governmentally subsidized public financing mechanism (Beck, Klapper, and Mendoza 2010). Credit guarantee schemes allow for the (partial) transfer of credit risk from a loan or a portfolio of loans. If the borrower defaults, the lender recovers the value of the guarantee. Guarantees are provided against a fee paid by the borrower, the lender, or both. In case of borrower default, the lender is usually obliged to proceed with the loan collection and to share the proceeds with the guarantor (Honohan 2010).

Preferential Equity

Because nonprofit organizations cannot issue equity shares, preferential equity is available only to for-profit recipients. As a result, social enterprises often take a for-profit legal form to attract preferential equity from social investors.

New legal forms of equity provide donors additional opportunities to diversify their philanthropic subsidies. These forms include common interest companies (CICs) in the United Kingdom (UK) and low-profit limited liability companies (L3Cs) in the United States. CICs are subject to a dividend and interest cap as well as an asset lock, meaning that assets may not be transferred or distributed to any organization apart from a CIC, a charity, or a similar body established outside the UK (Nicholls 2010). In the United States, L3Cs have three main requirements: (1) they must be organized to accomplish a charitable purpose, (2) they must be primarily created neither to accumulate property nor to earn a profit, and (3) they must not be created to further any political or legislative objective (Artz, Gramlich, and Porter 2012). With both new legal forms, equity investment allows enterprises to compete on the bundle of financial return and social impact available to private investors (Henderson and Malani 2009). The result is an investment universe that expands opportunities for blended value (Emerson 2003) and allows social investors to combine financial return and social impact.

Subsidy Instruments in the Social Entrepreneurial Lifecycle

Access to capital is an important element for a social enterprise to fulfill its mission. In general, social enterprises can access capital internally or externally. Internal financing is provided by cash flows generated through the provision of services or products. The products/services of the social enterprise can be paid either by the target group

themselves (e.g., microfinance) or by third-party beneficiaries (parents, employers, cross-subsidies such as “buy one-give one”). In cases where the target group lacks the ability to pay or where donors want to finance experimental pilots or innovative projects, internal financing may occur via third-party contracting arrangements such as public sector grants that outsource the provision of a public good or service or through grants that enter the social enterprise via the income statement (Morduch 1999; Lall and Park 2020).

Social enterprises can also use external financing such as equity or debt to cover temporary negative operating cash flows or to finance investment in long-term assets such as buildings, equipment or other infrastructure related expenses (Siqueira et al. 2018; Lall, Chen and Roberts 2020). However, since the mission of a social enterprise often places upside limits on financial return prospects, public and private donors often adapt their financing instruments through two mechanisms. First, donors can satisfice on the expected rate of financial return. Second, donors can adapt financing instruments to better meet the needs of social enterprises. As described in our typology, typical modifications include the use of a deferred payment schedule or grace period for debt instruments or the use of convertible equity that turns into grant funding in case of unexpected low performance.

The subsidized phase of social enterprises is typically thought of as indispensable for launching and maintaining socially-oriented activities until new commercial partners enter the company. In this respect, habit formation, a concept brought from social psychology (Verplanken, 2018) suggests that crowding-in will be stunted by the duration of the subsidized period. Indeed, some important habits are deeply connected to identity (Verplanken and Sie, 2019). Based on these findings, we speculate that entrenched

subsidy-dependent managerial habits die hard and can therefore prevent managers of social enterprises from attracting fresh commercial capital. That is, the successful attraction of subsidy funding can lead managers of socially driven organizations to identify and develop habits related to continued subsidization. The literature shows that financial decision making is affected by habits at both the macro-economic level (Carroll et al. 2000) and at the individual level (Lally and Gardner 2013).

The “habit” construct is recognized as a core feature to explain the limited use of information systems (Limayem et al. 2007), the loyalty of clients (Liu-Thompkins and Tam 2013), and more generally in decision-making style (Thunholm 2004). Accordingly, we contend that this fruitful conceptualization also applies to the pro-social vs. for-profit mindset. A key underlying mechanism relates to the type of subsidy instruments the enterprise attracts because some financial instruments are more prone than others to strengthen subsidy dependency and thus insulate the enterprise from competitive financial markets (Gomes and Michaelides 2003). Practically, managers working with subsidies associated with market distortions and soft budget constraints develop behavioral reflexes that take them further away from considering—both positive and negative—commercialization as a possible outcome of their organization. The subsequent habit formation is thus self-reinforcing: the actions of managers insulated from market discipline for a long time reinforce crowd-out signals.

The smart-subsidy scheme proposed by Morduch (2007) echoes the idea that long-lasting subsidization can have undesirable effects. Subsidies, especially monetary grants, are better designed when they are transparent, rule bound and time limited. Otherwise, they can create perverse habits that serve as crowding-out devices. Cheap and

long-term credits have also often been criticized and counter-productive (Adams, Graham, and Von Pischke 1984) since they have less incentives for beneficiaries to seek efficiency gains. Donors should therefore maintain “hard budget constraints” with clear “exit strategies” with the aim of minimizing distortions, mistargeting, and inefficiencies while maximizing social benefits (Armendariz and Morduch 2010).

Once a social enterprise establishes itself as a successful business, the revenue it generates will cover its costs. The challenge, therefore, lies in financing its startup and growth phases while simultaneously signaling commercial viability to profit-seeking investors. We argue that source variation and features of subsidy instruments combine in ways that either attract or deter commercial capital acquisition for social enterprises. We will use signaling theory to unpack these important dynamics.

Signaling Theory

Classical signaling theory refers to information asymmetries between two parties—the signaler (the entity of interest who possesses the information) and the receiver (the audience to whom this information is not otherwise observable but is perceived as useful) (Spence, 1973). In his formulation of signaling theory, Spence (1973) used the labor market to model the signaling function of education. In this context, potential employers lack information about the quality of job candidates. As a consequence, educational achievement can be a useful signal if it is positively related to unobservable employee productivity. Because lower quality candidates would not be able to withstand the rigors of higher education, higher quality job candidates obtain education to signal their quality and reduce information asymmetries with potential employers. In contrast to human capital theory, Spence’s model deemphasizes the role of education to increase

worker productivity and instead focuses on education as a mechanism to communicate otherwise unobservable characteristics of the job candidate (Weiss 1995).

The characteristics of both signaler and receiver are pertinent to the signaling process. The signaler must be able to undertake costly actions to generate signals that allow the receiver to distinguish low-quality candidates from high-quality candidates (Certo 2003; Gulati and Higgins 2003). Additionally, the signaler's status, visibility and identity determine the credibility of its signal (Cohen and Dean 2005; Pollock and Rindova 2003).

A variant of the classical signaling theory setup extends to situations where the focal entity (most typically, a firm) forms relational ties with the intention of signaling its quality to a receiving audience (Vasudeva, Nachum and Say 2018). Studies in this stream of research have investigated how a firm's relational ties with lawyers, board members, stockbrokers, and investors provide signals to market participants about the firm's otherwise unobservable qualities (Certo 2003; Gulati and Higgins, 2003; Sanders and Boivie 2004; Reuer, Tong, and Wu 2012). For instance, the presence of outside directors on the board may be interpreted as a signal of good corporate governance that distinguishes a focal firm from its competitors (Certo, Daily, and Dalton 2001).

Our theorization builds on these precedents to develop a signaling theory of a third-party intermediary whose actions in relation to the focal entity serve as an unintended signal of the focal entity's qualities to a receiving audience. More simply, we argue that subsidy providers (intermediary signalers) send signals to commercial investors (receiving audience) that reveal information about an underlying social enterprise (focal firm). We deviate from the classical two-party and relational ties models in four main ways. First, an intermediary signaler's association with the focal entity is characterized by the actions it undertakes with

the focal entity (i.e., how a donor designs a subsidy), rather than simply the presence of a relational tie to it. Second, the intermediary signaler’s actions generate “activating signals,” which bestow the expectation of certain qualities upon the focal entity (Connelly et al. 2011). Since the intermediary signaler may not possess full information about the focal entity, the credibility of the intermediary signaler relies upon the receivers’ perception that the intermediary possesses information about the focal entity that they do not have (Vasudeva, Nachum and Say 2018). For instance, although donors are also subject to information asymmetries when deciding to subsidize a social enterprise, commercial funders ascertain information from the funding relationship between donors and a social enterprise. Third, in contrast to the classical and relational signaling models, where signaling is explicitly intended to influence the perception of a receiving audience, the actions of a third-party intermediary signaler are primarily motivated by its own objectives, which may or may not overlap with a deliberate attempt to change the behavior of the receiving audience. Fourth, whereas signalers in the two-party signaling environment have incentives to distort information, intermediaries whose actions are not intended to modify the behavior of the receiver are less inclined to send false signals, making their signals more trustworthy (Vasudeva, Nachum and Say 2018).

In the propositions that follow, we develop arguments concerning the signaling effect that public and private donors send to commercial investors regarding the latent quality of social enterprises. Since the quality of a social enterprise cannot be measured directly, commercial investors frequently infer the quality of a social enterprise through observable variables such as management team, revenue growth or financial performance. We argue that subsidy providers create additional observable characteristics for commercial investors to

evaluate the commercialization potential of social enterprises. The observable characteristics subsidy providers convey to commercial investors include: (1) subsidy instrument features and (2) donor type. The organization's approach to resource acquisition signals its quality. Funder behavior is critical for social enterprises, which often face greater pressures from resource dependency than other types of organizations (Wry, Cobb, and Aldrich 2013). The presence of public and private donors can serve to both encourage and deter private investors, depending on the duration and type of donor involvement.

Crowding-in and Crowding-out

Two competing mechanisms explain this signaling environment: *crowding-out* and *crowding-in*. Classical crowding-out literature suggests that public subsidies to a recipient organization displace the donations of private donors because private donors (taxpayers) perceive government funding as a substitution for their donations (de Wit and Bekkers 2016). In contrast, crowding-in suggests that government subsidy signals an organization's effectiveness and is thus used as a "quality stamp" that encourages private donors to provide additional funding (Rose-Ackerman 1986; Pereira 2001; Hatano 2010; Jilke et al. 2019). However, in situations where social organizations have earned revenues, we argue that public *or private* subsidy can crowd-out or crowd-in private commercial capital, depending on the circumstances. Since all subsidy instruments potentially have both crowding-in and crowding-out effects depending on their intensity and duration within the business life cycle, we examine each instrument using the smart subsidy criteria established by Morduch (2007) and formalize our arguments as propositions. Smart subsidies induce crowding-in effects and are rule-bound, time limited and transparent (Morduch, 2007). By contrast, crowding-out occurs through what we call addictive subsidies, which are untargeted, sticky and opaque.

Grants. When grant funding is conditioned on the achievement of specific milestones, the focal firm faces consequences if it fails to meet expectations. As a result, high quality social enterprises are more likely to accept grant conditions than low quality social enterprises. The acceptance of grant conditions in turn signals outside commercial investors that the social enterprise is building capacity. Through grant conditions, donors can increase transparency and make grants rule-bound. Donors can also make clear that grants are only available during the start-up phase, after which the focal firm is expected to become self-sufficient. By restricting the time period of grant disbursements, the fear of ongoing grant dependency is reduced. Ideally, donors embed all three aspects into grant design to signal commercial investors that the focal firm will be a viable commercialization candidate. However, all three aspects of smart grant design can also serve as an effective crowding-in signal on their own.

By contrast, addictive grants signal that an organization will require ongoing subsidy. Untargeted cash support can lead to *soft budget constraints* (Kornai 1979), a concept borrowed from transition economics to frame the situation of firms that are permanently bailed out with subsidies. Since these grants are often delivered as operational support and come with “no-strings”, they are relatively sticky. Commercial private investors therefore interpret these grants as a signal that the organization will never earn “market” revenues, let alone reach operational break-even, where returns match investments. Our typology indicates that addictive grants will crowd-out commercial investors, who perceive the continued association of donors as a deterrent of institutional capacity. As a result, the risk of crowd-out is low during the initial phases of start-up but increases as the focal firm advances to maturity.

Proposition 1: The crowding-in effect of grants is strengthened by using smart subsidy criteria (transparent, rule-bound and time limited).

The crowding-in effects of in-kind grants manifest differently for private and public donors. Expertise gives private donors a competitive advantage over public donors for both tangible and intangible in-kind grants (Porter and Kramer 1999). For instance, private donors who have achieved substantial business success send a positive signal to commercial funders that a social organization is of high quality (Andreoni 2006). This is particularly relevant because social enterprises often lack entrepreneurial competencies associated with for-profit businesses (Smith, Cronley, and Barr 2012). Likewise, in-kind donations can help corporate donors to dispose of excess inventory, such as computer hardware, or to create goodwill and maintain institutional legitimacy (Seifert, Morris, and Bartkus 2003).

Proposition 2: The crowding-in effect of in-kind grants is strengthened when delivered by private donors rather than public donors.

Procurement. The government's procurement process can increase transparency and reduce market asymmetry by pushing sellers to disclose additional information. Since procurement arrangements are accompanied with specific contractual conditions, they are rule-bound by default. However, if procurement subsidies are not time limited, they can also create market distortion because they are equivalent to donors paying above-market prices, allowing sellers to receive additional margins with respect to the market. For instance, renewable energy support schemes pay focal firms above-market prices to make renewables competitive. Procurement subsidies thus satisfy the transparent and rule bound criteria but do not always satisfy the third smart subsidy criteria of time limited.

Proposition 3: The crowding-out effect of procurement subsidies is strengthened when they are not time limited.

Preferential Debt. The short-term use of subsidized interest rates can help the focal firm build a track record of debt repayment while they reach sufficient scale to afford market-rate instruments and thus serve as crowding-in instruments in the short-to-medium term. However, they can also induce crowding-out effects if the focal firm is reliant upon concessionary interest rates for long periods of time since it signals that the recipient firm is failing to reach internal efficiency gains and break even. In the worst case, the focal firm could have the repayment capacity to take on market-rate debt, but market-rate investors get crowded-out by donors who continue to issue new debt at subsidized rates. When established with transparent rules, interest rate subsidies serve as a good example of smart subsidy since they maximize social benefits by supporting firms with improving cost to revenue ratios.

Uncompensated grace periods allow the focal firm to have lower installments or forego them for a time. In the short term, grace periods allow the focal firm to scale before needing to repay any funds. When coupled with a waterfall payment structure, donors may be able to forego their installments during the grace period while commercial investors receive their percentage of the installment in full. However, grace periods create the risk of crowding-out by creating additional future risk for the cash flows of the focal firm. Since grace periods allow the focal firm to avoid financial discipline, they are more likely than other debt features to crowd-out commercial investors.

Proposition 4: The crowding-in effect of preferential debt is weakened when grace periods are used rather than interest rate subsidies or guarantees.

Although both public and private donors can provide guarantees in principle, in practice they are particularly attractive to politicians and state agencies. Public donors can leverage much larger loan amounts than they would be able to deliver at subsidized interest rates (Honohan 2010). Guarantees also help legitimize state support where subsidized interest rates might be perceived as market distorting and help mitigate risks that the private for-profit sector cannot effectively evaluate or will not bear. Guarantees lower the donor's (guarantor's) financial obligation when the only alternative is for the donor to fully finance the project or bear all the risks (Mody and Patro 1996). Since guarantees lower the risk for commercial investors in a specific transaction, they explicitly crowd-in commercial funders. To be considered as smart subsidy, guarantees should be made with the assumption that they are time limited, for instance by using them as demonstration projects to increase the faith of commercial investors in the repayment capacity of the focal firm.

Proposition 5: The crowding-in effect of guarantees is strengthened when delivered by public donors rather than private donors.

Preferential Equity. Theory in entrepreneurial finance suggests that specialized investors add value to the focal firm beyond what could be provided by generalist funders in early stages of development. A lack of sufficient value creation early in the business life cycle may force the focal firm to seek follow-up financing at worse terms from existing investors because of disinterest from outside investors (Schwienbacher 2013). In our context, donors serve the role of specialized investors who generally also accept a governance position (i.e., board seat). By providing value-add services such as oversight, ecosystem building and nonfinancial support, donors send crowd-in signals to commercial investors.

Nevertheless, rule bound conditions are particularly important in the design of smart preferential equity. If subsidized equity features only apply to donors, then commercial investors might be able to realize outsized returns, depending on competition from other funders. However, if subsidized ownership rights are imposed upon commercial investors, crowding-out is likely to occur because private investors would not want to adopt a dividend cap, accept restricted voting rights, face austerity measures, or be unable to sell their position in the social enterprise. Thus, smart preferential equity should be designed in a manner that does not limit the upside potential of commercial investors. Smart preferential equity should therefore seek exit opportunities via trade-sales to commercial investors in an effort to limit the duration of the subsidized phase.

Proposition 6: The crowding-in effect of preferential equity is strengthened when subsidized ownership rights do not extend to commercial funders.

Two additional propositions emerging from the typology relate to what we call cross-instrument crowd-in/crowd-out. Propositions 7 and 8 consider the inflection point of operational break even. Since grants do not need to be repaid, smart grants are optimal during formative stages of the business life cycle that build organizational capacity and professionalism, such as monetary grants to establish project viability and new product development or in-kind grants that instill market logics through the transfer of professional management techniques or greater knowledge of IT systems. Once operational break even has been achieved, donors can send stronger crowding-in signals via preferential debt.

Proposition 7: The crowding-out effect of smart grants is strengthened once a social enterprise has reached break even.

Proposition 8: The crowding-in effect of preferential debt is strengthened once a social enterprise has reached break even.

We bring the features of our typology and signaling model propositions together in Table 3. In the next section we apply this framework to the microfinance industry.

[Table 3 here]

Application to Microfinance

Over the past several decades, microfinance has emerged as a global tool in the fight against poverty (Cobb, Wry, and Zhao 2016). By providing financial services (credit, savings, insurance, etc.) to low-income populations excluded from the formal financial sector, MFOs help to alleviate household financial constraints and/or provide borrowers with capital to generate income (Hermes, Lensink, and Meesters 2011). The private nonprofit sector initially drove support for sustainable microfinance in response to the failed publicly subsidized microcredit programs of the 1960s and 1970s. Strong support from public donors followed a few years later (Adams, Graham, and Von Pischke 1984). In recent years, increasing commercialization of the sector has fueled industry growth and microfinance organizations (MFOs) now serve more than 200 million customers globally (Cull, Demirgüç-Kunt, and Morduch 2018). Nevertheless, MFOs still face substantial challenges to become financially sustainable and independent from donors (D’Espallier, Hudon and Szafarz 2013).

Despite continued reliance on subsidy, the microfinance industry has changed dramatically over the last twenty years and is now characterized by a growing number of commercial banks, some of which are quoted on stock exchanges (Brière and Szafarz 2015). This commercialization has been repeatedly criticized by influential players, including Nobel

Laureate Muhammad Yunus, who views microfinance IPOs as a threat to the moral integrity of the sector. More broadly, the evolution of the microfinance sector triggered the emergence of a “mission drift” conversation (Grimes, Williams and Zhao 2019; Varendh-Mansson, Wry and Szafarz 2020), in which organizational design and path dependency are key concerns (Santos, Pache, and Birkholz 2015; Ramus and Vaccar 2017).

Scholars have explored a range of topics related to the performance of MFOs, from their financial, social and even environmental objectives (Hermes and Hudon 2018), the drivers of performance (Cull, Demirgüç -Kunt, and Morduch 2018), and the tensions and trade-offs of balancing financial and social goals (Reichert 2018; Wry and Zhao 2018). Additional literature streams investigate the internal management practices of MFOs related to top level management and corporate governance (Galema, Lensink, and Mersland 2012), loan officers (van den Berg, Lensink and Servin 2015; Labie et al. 2012), and the efficacy of microfinance to reduce poverty and achieve other social outcomes (Banerjee et al. 2015).

Our case extends previous work by Morduch (1999) on the role of subsidies in microfinance. Whereas Morduch focuses on subsidies to a socially-oriented MFO (Grameen Bank) that aims for operational break even, we apply our typology and signaling model to illustrate how subsidies can drive the commercialization of a profit-oriented social enterprise: Banco Compartamos. Although the case of Compartamos is extreme since the social enterprise would ultimately IPO on the stock exchange, it is illustrative precisely because it has gone through the full social entrepreneurial lifecycle: from experimental non-profit to publicly listed company.

Compartamos: Subsidy and Donation Timeline

Inspired by Mother Theresa's commitment to the poor when she visited Mexico in 1982, Jose Ignacio Avalos decided to create the philanthropic organization Gente Nueva, Compartamos's predecessor, in 1984 to promote a youth movement of social change and contribute to the economic development of Mexico. In 1990, after obtaining a \$50K grant for staff training from USAID, Gente Nueva started issuing microloans to pilot a microcredit project in the poorest Mexican states of Oaxaca and Chiapas (Dugan and Goodwin-Groen 2005). From these modest beginnings, Compartamos began a seventeen-year journey toward becoming one of the largest MFOs in Latin America.

Data inventory. We collected data from three sets of secondary sources: (1) financial data from MixMarket, an industry specific dataset of market-oriented MFOs; (2) publicly available documents from Compartamos; and (3) academic literature, case studies and donor reports. We used these three data sources to triangulate all subsidy flows to Compartamos from the start of its microfinance program in 1990 until its IPO on the stock exchange in 2008. Based on these secondary sources, we construct and present Compartamos's historical timeline in table 4 and examine the various subsidy instruments used and their associated signaling effects in the following paragraphs.

[Table 4 here]

As table 4 shows, Compartamos received several grants, allowing us to investigate Propositions 1, 2 and 8. The provision of a credit guarantee, preferential equity and preferential debt allow us to investigate Propositions 5, 6 and 7. However, Compartamos

did not report any procurement or grace period subsidies, which prevents us from testing Propositions 3 and 4.

Grants. From 1990 to 2000, when Compartamos was registered as an NGO and still early in its life cycle, public and private donors pushed the social enterprise down a path of extreme commercialization, encouraging the implementation of sophisticated information technology solutions and benchmarking performance to financial milestones and targets (Rosenberg 2007). Our framework suggests that these pressures were explicitly designed to crowd-in commercial capital. The evidence plays in favor of Proposition 1, which suggests that smart grant features send stronger signals to potential commercial funders.

In its early years, the organization primarily used cash grants, first to experiment with microcredit as a poverty reduction tool (\$50K from USAID) and then to provide technical assistance (\$150K from Inter-American Development Bank [IDB]). The grants helped Gente Nueva spin off the microcredit program into a separate nonprofit entity, Compartamos NGO, in 1991. Initially provided by public bodies (USAID and IDB), these grants came with strict reporting requirements and specific instructions on the use of funds. By 1995, Compartamos NGO achieved operational self-sufficiency, in other words, operational break-even. At this stage, donors could likely have transitioned from grants to the use of preferential debt, which yields weak evidence against Proposition 7.

When Consultative Group to Assist the Poor (CGAP) was initiated in 1995 to advance access to financial services for poor families, the World Bank provided \$27 million of the initial \$32 million to establish a three-year “core fund” for CGAP (World Bank 2002). In 1996, CGAP issued a \$2 million conditional grant to Compartamos NGO that was distributed in three yearly tranches. The first tranche was designated for the installation of

accounting and management information systems. The subsequent tranches were dependent on performance benchmarks: (1) an arrears rate below 10 percent, (2) client growth of at least 25 percent annually, and (3) an annual target for return on assets (Dugan and Goodwin-Groen 2005). These conditions imposed hard budget constraints on Compartamos NGO, helping the organization demonstrate its ability to hit the type of financial targets that fully commercial private investors could find attractive.

From 1995 to 1998, Alfredo Harp Helu, the president of the Citicorp subsidiary Banamex, advised the organization for free. He brought considerable banking expertise, advising the MFO to modify its lending techniques, strengthen loan supervision procedures, and raise its effective monthly interest rate to drive growth from retained earnings (Dugan and Goodwin-Groen 2005). The involvement of Harp is reflective of the relative advantage of private donors over public funders to deliver in-kind grant support, lending support for Proposition 2. Harp's advisement signaled to private investors that Compartamos NGO was becoming more professionalized and disciplined; these qualities are styled as corporate intangibles in our typology. Through this in-kind support, Helu helped Compartamos NGO to scale up, train loan officers, streamline loan decisions, and follow up on delinquent loans, as well as improve information management within the MFO. He also created connections to other private philanthropists. The connections forged by Helu reflect the importance of personal connections to enable access to grant financing (Lall et al. 2019; Zhan and Tang 2016; Suarez and Gugerty 2016).

Preferential Debt: Interest Rates. In 1993, Compartamos NGO received \$500K in preferential debt at a highly concessional interest rate from the public Inter-American Development Bank (IDB). These funds were instrumental in building the organization's loan

portfolio. However, according to Armendáriz and Morduch (2010), Compartamos' operational inefficiencies were a big part of why they charged such high interest rates. Together, this indicates that Compartamos might have been better served simply using additional smart grants prior to operational break even (lending support for Proposition 8). However, after Compartamos NGO became a for-profit finance company in 2000, it also received over \$30 million in loans from public development agencies and \$15 million from private socially oriented investors, although these loans are reported to be at market interest rates or above (Rosenberg 2007). While they undoubtedly helped Compartamos demonstrate its ability to take on debt obligations, since they were not explicitly subsidized, it's hard to determine whether they lend further support to Proposition 8.

Preferential Debt: Guarantee. In 2002, the International Finance Corporation (IFC) partially guaranteed the issuance of roughly \$70 million in bonds on the Mexican securities exchange for a nominal fee of 2.5 percent of the guaranteed amount (Rosenberg 2007). The loan guarantee was used as a one-time subsidy, allowing Compartamos LLC to demonstrate its repayment capacity to commercial investors. In total, with an additional \$65 million in debt from Mexican banks and commercial lenders, the \$6.3 million in explicit public donor subsidies attracted over \$130 million in purely private investment (Rosenberg 2007). The guarantee scheme offers strong support for Proposition 5.

Preferential Equity. In 2000, to tap commercial funds for faster growth, Compartamos NGO and other investors set up a regulated finance company, Compartamos LLC, organized as a for-profit corporation with a paid-in capital of \$6 million. At this stage, Compartamos had difficulty attracting private equity but could reasonably crowd-in fully commercial debt, thanks in part to the financial discipline instilled through previous grants

and technical assistance. Compartamos's inability to attract private equity despite its encouraging financial performance could be because few test cases of transitioning an NGO into a for-profit finance company existed at that time. Reflective of the role of specialized early-stage investors in our signaling framework, USAID granted \$2 million to Accion, a not-for-profit international provider of technical assistance and investment capital to MFOs. In turn, Accion provided \$200K in technical assistance to Compartamos NGO, gave Compartamos NGO \$800K that it used to buy stock in Compartamos LLC, and lent the remaining \$1 million as preferential debt to the newly formed Compartamos LLC. The shareholders of Compartamos LLC thus included Compartamos NGO, as well as ProFund and Accion International. Together, these social agencies held 68 percent of the shares in Compartamos LLC (Ashta and Hudon 2012); figure 2 highlights the subsidy flows.

[Figure 2 here]

In 2001, IFC of the World Bank came in as an equity investor, while in 2005 ProFund International exercised a put option to liquidate its equity shares at a multiple of 2.2 times the book value (BV), an exceptional return considering that ProFund's other microfinance equity exits ranged from 0.9 to 1.4 of BV (Goodman 2009). This is further highlighted in the Calmeadow divestiture report on ProFund, which shows that the shares of the commercially-oriented ProFund went to existing social shareholders within Compartamos rather than being shopped to other market-oriented investors (Calmeadow 2006). The entrance of a public donor and the profitable exit of a more commercially-oriented investment fund demonstrates that crowding-in effects are not path dependent and

that, in some cases, public donors can crowd-out equity positions that are attractive to for-profit commercial investors.

By 2006, Compartamos LLC obtained its full banking license and transformed into Compartamos BANK to accept customer deposits. The final step for donors to crowd-in private investors was to transition out of their equity positions. In the April 2007 IPO, existing investors sold 30 percent of their shares to new investors stock for \$470 million, more than twelve times the firm's BV. No new stock was issued. The IPO itself was thirteen times oversubscribed, a massive success by financial market standards, essentially translating to a return of 100 percent per year compounded for eight years for the initial, donative investors (Ashta and Hudon 2012).

New investors were primarily mainstream international fund managers and other truly commercial investors, in other words, investors with no social motivation. Of the IPO proceeds, two-thirds (\$300 million) went to public-purpose institutions—IFC, Accion, and Compartamos NGO—while one-third went into the pockets of private shareholders (Rosenberg 2007). Ultimately, the IPO lends support for Proposition 6 since commercial investors did not have to take on any equity restrictions.

For some, the Compartamos IPO signaled the social donor's turn to the dark side. According to Yunus, "Microcredit should be about helping the poor to get out of poverty by protecting them from moneylenders, not creating new ones" (Chu and Cuellar 2008, p. 1). In contrast, the World Bank and IFC maintain that earning outsized returns does not conflict with the developmental mandate of the IFC because the IFC "provides political risk comfort to investors, takes special risks that others cannot handle such as extending maturities in emerging markets and plays trailblazer with its demonstration projects" (World Bank 2002,

p. 54). Thus, the IFC takes on projects that the private sector would not. By adapting the features of their financial products, the IFC is able to bridge the transition period to attract commercial investors.

Conclusion

Set against the broader context of understanding the interdependencies of government and private organizations (Paarlberg and Zuhlke 2019), this article is a first step toward unpacking how public and private subsidies might crowd-in or crowd-out commercial capital for social enterprises. The role of signaling is a core concept to alleviate information asymmetry in corporate finance. However, in a context of double-bottom-line institutions, the menu of funding instruments diverges substantially from traditional theory.

Simultaneously, the literature on private philanthropy and public subsidies tends to disregard the nature of the tools used to advance the charitable agenda. However, we demonstrate that differences in these financial tools matter significantly. Not all donors have access to the same set of funding opportunities, and this represents an intrinsic limitation and has practical consequences. Our typology suggests that private donors are uniquely positioned to provide in-kind grants that are key to develop financial discipline while public donors can leverage credit guarantees to explicitly crowd-in commercial investors. These comparative advantages may reflect the divergent principal-agent relationships of public and private donors.

In democratically elected societies, citizens evaluate their satisfaction or displeasure with the government and indicate their preferences by voting in elections. As a result, accountability mechanisms are critical in the democratic process since they provide voters

with the information needed to judge the effectiveness and conduct of the government (Bovens 2010). In the face of austerity, public subsidies that crowd-in additional investment from the private sector are particularly attractive. The guarantee schemes in our typology allow governments to leverage much larger loan amounts than they would be able to deliver at subsidized interest rates. By contrast, private donors operate under different sensitivities to time constraints than public actors. Once political consensus has been reached on a particular public good or social program, public subsidies are considerably stickier and may be harder to withdraw. By contrast, once private donors do not derive any benefit from a particular social cause or face difficulty ascertaining the social benefits, funding for the cause will soon disappear (Henderson and Malani 2009).

Our article provides three contributions to the literature. First, we construct a new typology of subsidy instruments that accounts for the specificities of private donors. Second, we use our typology to identify how public and private subsidies may trigger both crowd-in and crowd-out along the commercialization path. Our main theoretical contribution is that crowding-out and crowding-in effects are better understood when they are moderated by the signaling effects of specific subsidy instruments used by public and private donors. Carlos Danel's (Compartamos founder) own observations support this:

[P]hilanthropists can now have a big impact on other non-profits by 'bringing to bear their business expertise, by treating the people they work with as business partners who they are helping to work their way out of reliance on the donor community. It is easier for these philanthropists to do that than public donor institutions with more bureaucratic structures [such as the World Bank], and with no obvious alternative use for the capital. But they need to be smart. If they don't see themselves as enablers of microfinance institutions moving to the private sector, they could crowd out private investors by sending a signal that there will be perpetual reliance on philanthropy'" (Bishop and Green 2010, 133)

Our third contribution extends the classical two-party signaling model to an intermediary signaling model to highlight the information that public and private donors transmit to prospective commercial funders of social enterprise, particularly in microfinance. Existing research on signaling has typically ignored the perspective of using funders as a signaler (Vasudeva, Nachum and Say 2018). Our analysis demonstrates that the impetus for financial stability can be driven by both public and private donors, who signal the quality of the recipient organization using different subsidy instruments. Through the application of the typology to the field of microfinance, we demonstrate how public and private subsidies crowd-in, or crowd-out, private investment. Subsidies were specifically designed to help Compartamos attract commercial capital. That is, the subsidies provided support in the form of technical assistance, capacity building, and the initial equity base for Compartamos' transition from a nonprofit to a for-profit legal structure. The credit guarantee by the IFC, which helped Compartamos issue public bonds on the Mexican bond market, provided the final nudge that allowed Compartamos to demonstrate its repayment capacity at commercial rates. It also enabled the bank to issue future bonds without public or private donor support. This demonstrates the crowding-in effect.

Our approach has limitations. First, our comparison aggregates a diverse range of actors into public and private cohorts. Both private and public donors consist of heterogeneous philanthropic profiles that may require further nuance beyond the broad generalizations that we draw in this article. Nevertheless, we are confident that substantial differences between public and private actors remains an important distinction in the field of subsidy design. Second, we do not account for indirect grants or “infrastructure” that supports social ventures, such as incubators, training programs or accelerators. Recent work

suggests that accelerator participation helps social enterprises attract more equity funding (Lall, Chen and Roberts 2020). While we roughly capture these indirect subsidy types through intangible, in-kind grants, we believe that further granularity into subsidy mechanisms may come at the expense of reduced comprehensibility. Third, we draw upon a large range of philanthropic activities using literature from diverse fields of study. An empirical approach using interviews that focuses on a particular sector, such as fair trade or microfinance donors, could add valuable insights. Fourth, we also acknowledge that our empirical application relies upon a single case study that relies upon secondary data and public sources and is unlikely to reflect the precise reality in a heterogeneous field such as microfinance, which encompasses nonprofit, cooperative and for-profit organizations. While this obviously limits transposability to other contexts, we believe that is important to complement large-scale quantitative studies continue that ignore subsidy structure when testing crowding-in hypotheses related to signaling (Brooks 2000; Lall and Park 2020). The case of Compartamos was selected since the organization has gone through multiple phases of transformation, attracted interest from both public and private actors and is illustrative of the business lifecycle of MFIs that want to provide financial services at a large scale without long-term donor support. Fifth, our framework does not focus on the relationship between financing sources and the social mission of the organization. As donors push social enterprises towards financial self-sufficiency, there is potential for mission drift (Armendariz and Szafarz 2011, Mersland and Strøm 2010). Thus, future work could extend our framework to examine the impact of subsidy design on mission drift. Finally, we acknowledge that not all social enterprise aim for high profitability. Boundary conditions for the signaling framework are likely limited to high-growth social enterprises with earned

revenues. Nevertheless, we believe that these enterprises are a rapidly growing phenomenon where subsidy providers (such as impact investors) will increasingly look to as catalysts to advance the public agenda (Barber, Morse and Yasuda 2021).

Understanding the signals and features of subsidy instruments can help government agencies and private donors optimize subsidy design. The role of subsidies to stimulate private investment via “blended value” investments is gaining traction within policy circles and should therefore be investigated further. Our framework provides a way forward.

References

- Adams, Dale W., Douglas H. Graham, and John D. Von Pischke. 1984. *Undermining Rural Development with Cheap Credit*. Boulder, CO: Westview Press.
- Agranoff, Robert, and Michael McGuire. 2001. "Big questions in public network management research." *Journal of Public Administration Research and Theory* 11 (3): 295–326.
- André, Kevin, and Anne-Claire Pache. 2016. "From caring entrepreneur to caring enterprise: Addressing the ethical challenges of scaling up social enterprises." *Journal of Business Ethics* 133 (4): 659–675.
- Andreoni, James. 2006. "Leadership Giving in Charitable Fundraising." *Journal of Public Economic Theory* 8(1): 1–22.
- Armendáriz, Beatriz, and Jonathan Morduch. 2010. *The Economics of Microfinance*. 2nd ed. Cambridge, MA: MIT Press.
- Armendáriz, Beatriz, and Ariane Szafarz. 2011. "On Mission Drift in Microfinance Institutions." *The Handbook of Microfinance*. pp. 341-366.
- Artz, Nancy, Jeffrey Gramlich, and Terry Porter. 2012. "Low-Profit Limited Liability Companies (L3Cs)." *Journal of Public Affairs* 12 (3): 230–38.
- Ashta, Arvind, and Marek Hudon. 2012. "The Compartamos Microfinance IPO: Mission Conflicts in Hybrid Institutions with Diverse Shareholding." *Strategic Change* 21 (7–8): 331–41.
- Augsburg, Britta, and Cyril Fouillet. 2013. "Profit Empowerment: The Microfinance Institution's Mission Drift." *The Credibility of Microcredit*. Brill, 199-226.

- Bacq, Sophie, and Kimberly A. Eddleston. 2018. "A resource-based view of social entrepreneurship: How stewardship culture benefits scale of social impact." *Journal of Business Ethics* 152 (3): 589–611.
- Banerjee, Abhijit, Esther Duflo, Rachel Glennerster, and Cynthia Kinnan. 2015. "The miracle of microfinance? Evidence from a randomized evaluation." *American Economic Journal: Applied Economics* 7(1): 22–53.
- Barber, Brad M., Adair Morse, and Ayako Yasuda. 2021. "Impact investing." *Journal of Financial Economics* 139 (1): 162-185.
- Battilana, Julie, and Silvia Dorado. 2010. "Building sustainable hybrid organizations: The case of commercial microfinance organizations." *Academy of Management Journal* 53 (6): 1419–1440.
- Beck, Thorsten, Leora F. Klapper, and Juan Carlos Mendoza. 2010. "The Typology of Partial Credit Guarantee Funds around the World." *Journal of Financial Stability* 6 (1): 10–25.
- Bishop, Matthew, and Michael Green. 2010. *Philanthrocapitalism: How giving can save the world*. Bloomsbury Publishing USA.
- Bloom, Paul N., and Aaron K. Chatterji. 2009. "Scaling social entrepreneurial impact." *California Management Review* 51 (3): 114–133.
- Bogan, Vicki L. 2012. "Capital structure and sustainability: An empirical study of microfinance institutions." *Review of Economics and Statistics* 94 (4): 1045-1058.
- Bradach, Jeffrey L. 2003. "Going to scale: The challenge of replicating social programs." *Stanford Social Innovation Review* 19–25.
- Brest, Paul. 2003. "Smart Money." *Stanford Social Innovation Review* 1 (3): 44–53.

- Breton, Albert. 1965. "A Theory of Government Grants." *Canadian Journal of Economics and Political Science* 31 (2): 175–87.
- Brière, Marie, and Ariane Szafarz. 2015. "Does Commercial Microfinance Belong to the Financial Sector? Lessons from the Stock Market." *World Development* 67: 110–125.
- Brooks, Arthur C. 2000. "Public Subsidies and Charitable Giving: Crowding Out, Crowding In, or Both?" *Journal of Policy Analysis and Management* 19 (3): 451–64.
- Calmeadow. 2006. "Pro Fund Internacional divestiture report" Accessed December 15, 2019. <http://www.calmeadow.com/pdf/profund.pdf>
- Carroll, C. D., Overland, J., & Weil, D. N. (2000). Saving and growth with habit formation. *American Economic Review*, 90(3), 341-355.
- Certo, S. Trevis, Catherine M. Daily, and Dan R. Dalton. 2001. "Signaling firm value through board structure: An investigation of initial public offerings." *Entrepreneurship Theory and Practice* 26 (2): 33–50.
- Certo, S. Trevis. 2003. "Influencing initial public offering investors with prestige: Signaling with board structures." *Academy of Management Review* 28 (3): 432-446.
- Choi, Donwe, Frances S. Berry, and Adela Ghadimi. 2020. "Policy design and achieving social outcomes: A comparative analysis of social enterprise policy." *Public Administration Review* 80 (3): 494–505.
- Chu, Michael, and Regina Garcia Cuellar. 2008. *Banco Compartamos: Life after the IPO*. Harvard Business School Case (308–094), February 2008 (Revised July 2008).

- Cobb, J. Adam, Tyler Wry, and Eric Yanfei Zhao. 2016. "Funding Financial Inclusion: Institutional Logics and the Contextual Contingency of Funding for Microfinance Organizations." *Academy of Management Journal* 59 (6): 2103–31.
- Cohen, Boyd D., and Thomas J. Dean. 2005. "Information asymmetry and investor valuation of IPOs: Top management team legitimacy as a capital market signal." *Strategic Management Journal* 26 (7): 683–690.
- Connelly, Brian L., S. Trevis Certo, R. Duane Ireland, and Christopher R. Reutzel. 2011. "Signaling Theory: A Review and Assessment." *Journal of Management* 37 (1): 39–67.
- Cornée, Simon. 2019. "The relevance of soft information for predicting small business credit default: Evidence from a social bank." *Journal of Small Business Management* 57(3): 699–719.
- Cozarenco, Anastasia, and Ariane Szafarz. 2020. "The regulation of prosocial lending: Are loan ceilings effective?" *Journal of Banking & Finance* 121: 105979.
- Cull, Robert, Asli Demirgüç-Kunt, and Jonathan Morduch. 2018. "The microfinance business model: Enduring subsidy and modest profit." *The World Bank Economic Review* 32 (2): 221–244.
- D'Espallier, Bert, Marek Hudon, and Ariane Szafarz. 2013. "Unsubsidized Microfinance Institutions." *Economics Letters* 120 (2): 174–76.
- de Wit, Arjen, and René Bekkers. 2016. "Government Support and Charitable Donations: A Meta-Analysis of the Crowding-Out Hypothesis." *Journal of Public Administration Research and Theory* 27 (2): 301–19.

- Dees, Gregory J., Beth Battle Anderson, and Jane Wei-Skillern. 2004. "Scaling social innovation: Strategies for spreading social innovations." *Stanford Social Innovation Review* 1: 34–43.
- Di Domenico, MariaLaura, Helen Haugh, and Paul Tracey. 2010. Social Bricolage: Theorizing Social Value Creation in Social Enterprises." *Entrepreneurship Theory and Practice* 34 (4): 681–703.
- Dobson, Kieran, Sarah Boone, Petra Andries, and Alain Daou. 2018. "Successfully creating and scaling a sustainable social enterprise model under uncertainty: The case of ViaVia Travellers Cafés." *Journal of Cleaner Production* 172: 4555–4564.
- Dugan, Maggie, and Ruth Goodwin-Groen. 2005. *Donors Succeed by Making Themselves Obsolete: Compartamos Taps Financial Markets in Mexico*. CGAP Case Study, Washington DC: CGAP.
- Duncan, Brian. 2004. "A Theory of Impact Philanthropy." *Journal of Public Economics* 88 (9–10): 2159–80.
- Ebrahim, Alnoor, and V. Kasturi Rangan. 2014. "What impact? A framework for measuring the scale and scope of social performance." *California Management Review* 56 (3): 118–141.
- Ellwein, Leon B., Ravilla D. Thulasiraj, A. R. Boulter, and Shambhu P. Dhittal. 1998. "Estimating Costs of Programme Services and Products Using Information Provided in Standard Financial Statements." *Bulletin of the World Health Organization* 76 (5): 459–67.

- Emerson, Jed. 2003. "The Blended Value Proposition: Integrating Social and Financial Returns." *California Management Review* 45 (4): 35–51.
- Falck, Oliver, and Stephan Heblich. 2007. "Corporate social responsibility: Doing well by doing good." *Business Horizons* 50 (3): 247–254.
- Galema, Rients, Robert Lensink, and Roy Mersland. 2012. "Do powerful CEOs determine microfinance performance?" *Journal of Management Studies* 49 (4): 718–742.
- Gomes, Francisco and Alexander Michaelides. 2003. "Portfolio Choice with Internal Habit Formation: A Life-Cycle Model with Uninsurable Labor Income Risk." *Review of Economic Dynamics* 6: 729–766.
- Goodman, Patrick. 2009. "Raising MFI Equity through Microfinance Investment Funds." In *New Partnerships for Innovation in Microfinance*, 2nd ed, edited by Ingrid Matthäus-Maier and John D. Von Pischke, 17–45. Berlin Heidelberg: Springer.
- Grimes, Matthew G., Trenton Alma Williams, and Eric Yanfei Zhao. 2019. "Anchors Aweigh: The Sources, Variety, and Challenges of Mission Drift." *Academy of Management Review* 44 (4): 819–845.
- Gulati, Ranjay, and Monica C. Higgins. 2003. "Which ties matter when? The contingent effects of interorganizational partnerships on IPO success." *Strategic Management Journal* 24 (2): 127–144.
- Hartley, Jean, and John Benington. 2006. "Copy and paste, or graft and transplant? Knowledge sharing through inter-organizational networks." *Public Money and Management* 26(2): 101–108.

- Hatano, Toshiya. 2010. "Crowding-In of Public Investment on Private Investment." *Public Policy Review* 6 (1): 105–20.
- Hayllar, Mark Richard, and Roger Wettenhall. 2013. "As public goes private, social emerges: The rise of social enterprise." *Public Organization Review* 13 (2): 207–217.
- Henderson, M. Todd, and Anup Malani. 2009. "Corporate Philanthropy and the Market for Altruism." *Columbia Law Review* 109: 571–627.
- Hermes, Niels, and Marek Hudon. 2018. "Determinants of the performance of microfinance institutions: A systematic review." *Journal of Economic Surveys* 32 (5): 1483–1513.
- Hermes, Niels, Robert Lensink, and Aljar Meesters. 2011. "Outreach and Efficiency of Microfinance Institutions." *World Development* 39 (6): 938–48.
- Honohan, Patrick. 2010. "Partial Credit Guarantees: Principles and Practice." *Journal of Financial Stability* 6 (1): 1–9.
- Hudon, Marek., Marc Labie, and Patrick Reichert. 2020. "What Is a Fair Level of Profit for Social Enterprise? Insights From Microfinance." *Journal of Business Ethics*, 162(3), 627-644.
- Jilke, Sebastian, Jiahuan Lu, Chengxin Xu, and Shugo Shinohara. 2019. "Using Large-Scale Social Media Experiments in Public Administration: Assessing Charitable Consequences of Government Funding of Nonprofits." *Journal of Public Administration Research and Theory* 29(4): 627-639.
- Jones, David. 2011. "Recent reforms to promote social responsibility procurement in east Asian states: A comparative analysis." *Journal of Public Procurement* 11 (1): 61.

- Kerlin, Janelle A., ed. 2009. *Social Enterprise: A Global Comparison*. Lebanon: University Press of New England.
- Kornai, János. 1979. "Resource-Constrained versus Demand-Constrained Systems." *Econometrica* 47 (4): 801–19.
- Labie, Marc, Pierre-Guillaume Méon, Roy Mersland, and Ariane Szafarz. 2015. "Discrimination by microcredit officers: Theory and evidence on disability in Uganda." *The Quarterly Review of Economics and Finance* 58: 44–55.
- Lall, Saurabh A., and Jacob Park. 2020. "How Social Ventures Grow: Understanding the Role of Philanthropic Grants in Scaling Social Entrepreneurship." *Business & Society* DOI: 10.1177/0007650320973434.
- Lall, Saurabh A., Li-Wei Chen, and Peter W. Roberts. 2020. "Are we accelerating equity investment into impact-oriented ventures?" *World Development* 131: 1–12.
- Lall, Saurabh A., Li-Wei Chen, and Abigayle Davidson. 2019. "The Expat Gap: Are Local-Born Entrepreneurs in Developing Countries at a Disadvantage when Seeking Grant Funding?" *Public Administration Review* 79(6): 880–894.
- Lally, P., and Gardner, B. 2013. "Promoting habit formation." *Health Psychology Review*, 7(sup1), S137-S158.
- Limayem, Moez, Sabine Gabriele Hirt, and Christy MK Cheung. 2007. "How Habit Limits the Predictive Power of Intention: The Case of Information Systems Continuance." *MIS Quarterly*, 705-737.
- Liu-Thompkins, Yuping, and Leona Tam (2013). "Not all repeat customers are the same: Designing effective cross-selling promotion on the basis of attitudinal loyalty and habit." *Journal of Marketing* 77(5): 21-36.

- McGoey, Linsey. 2014. "The philanthropic state: market–state hybrids in the philanthrocapitalist turn." *Third World Quarterly* 35 (1): 109–125.
- Mersland, Roy, and R. Øystein Strøm. 2010. "Microfinance mission drift?" *World Development* 38 (1): 28–36.
- Mody, Ashoka, and Dilip K. Patro. 1996. "Valuing and Accounting for Loan Guarantees." *The World Bank Research Observer* 11 (1): 119–42.
- Molecke, Greg, and Jonatan Pinkse. 2017. "Accountability for social impact: A bricolage perspective on impact measurement in social enterprises." *Journal of Business Venturing* 32 (5): 550–568.
- Morduch, Jonathan. 1999. "The role of subsidies in microfinance: Evidence from the Grameen Bank." *Journal of Development Economics* 60 (1): 229–248.
- Morduch, Jonathan. 2007. "Smart Subsidies." In *Microfinance and Public Policy: Outreach, performance and Efficiency*, edited by Bernd Balkenhol, 72–83. New York: Palgrave.
- Moulton, Stephanie. 2009. "Putting Together the Publicness Puzzle: A Framework for Realized Publicness." *Public Administration Review* 69 (5): 889–900.
- Ni, Na, and Xueyong Zhan. 2017. "Embedded Government Control and Nonprofit Revenue Growth." *Public Administration Review* 77 (5): 730–42.
- Nicholls, Alex. 2010. "Institutionalizing Social Entrepreneurship in Regulatory Space: Reporting and Disclosure by Community Interest Companies." *Accounting, Organizations and Society* 35 (4): 394–415.

- Paarlberg, Laurie E., and Samantha Zuhlke. 2019. "Revisiting the theory of government failure in the face of heterogeneous demands." *Perspectives on Public Management and Governance* 2 (2): 103-124.
- Pereira, Alfredo M. 2001. "On the Effects of Public Investment on Private Investment: What Crowds in What?" *Public Finance Review* 29 (1): 3–25.
- Pollock, Timothy G., and Violina P. Rindova. 2003. "Media legitimation effects in the market for initial public offerings." *Academy of Management Journal* 46 (5): 631–642.
- Porter, Michael E., and Mark R. Kramer. 1999. "Philanthropy's New Agenda: Creating Value." *Harvard Business Review* 77: 121–31.
- Ramus, Tommaso, and Antonio Vaccaro. 2017. "Stakeholders Matter: How Social Enterprises Address Mission Drift." *Journal of Business Ethics* 143: 307–322.
- Reichert, Patrick. 2018. "A meta-analysis examining the nature of trade-offs in microfinance." *Oxford Development Studies* 46 (3): 430–452.
- Reuer, Jeffrey J., Tony W. Tong, and Cheng-Wei Wu. 2012. "A signaling theory of acquisition premiums: Evidence from IPO targets." *Academy of Management Journal* 55 (3): 667–683.
- Rose-Ackerman, Susan. 1986. "Do Government Grants to Charity Reduce Private Donations?" In *The Economics of Nonprofit Institutions*, edited by S. Rose-Ackerman, 313–29. New York: Oxford University Press.
- Rosenberg, Richard. 2007. *CGAP Reflections on the Compartamos Initial Public Offering: A Case Study on Microfinance Interest Rates and Profits*. CGAP Focus Note 42. Washington, DC: Consultative Group to Assist the Poor.

- Salamon, Lester M. 2014. *New Frontiers of Philanthropy: A Guide to the New Tools and Actors Reshaping Global Philanthropy and Social Investing*. New York, NY: Oxford University Press.
- Salamon, Lester. M. 2015. *The resilient sector revisited: The new challenge to nonprofit America*. Brookings Institution Press.
- Sanders, Wm Gerard, and Steven Boivie. 2004. "Sorting things out: Valuation of new firms in uncertain markets." *Strategic Management Journal* 25 (2): 167–186.
- Santos, Filipe, Anne-Claire Pache, and Christoph Birkholz. 2015. "Making Hybrids Work: Aligning Business Models and Organizational Design for Social Enterprises." *California Management Review* 57 (3): 36–58.
- Schneider, Aaron. 2017. "Social entrepreneurship, entrepreneurship, collectivism, and everything in between: Prototypes and continuous dimensions." *Public Administration Review* 77(3): 421–431.
- Schwartz, Gerd, and Benedict Clements. 1999. "Government subsidies." *Journal of Economic Surveys* 13 (2): 119–148.
- Schwienbacher, Armin. 2013. "The entrepreneur's investor choice: The impact on later-stage firm development." *Journal of Business Venturing* 28 (4): 528–545.
- Seifert, Bruce, Sara A. Morris, and Barbara R. Bartkus. 2003. "Comparing Big Givers and Small Givers: Financial Correlates of Corporate Philanthropy." *Journal of Business Ethics* 45 (3): 195–211.
- Siqueira, Ana Cristina O., Nadja Guenster, Tom Vanacker, and Saskia Crucke. 2018. "A longitudinal comparison of capital structure between young for-profit social and commercial enterprises." *Journal of Business Venturing* 33 (2): 225–240.

- Smith, Brett R., Maria L. Cronley, and Terri F. Barr. 2012. "Funding Implications of Social Enterprise: The Role of Mission Consistency, Entrepreneurial Competence, and Attitude toward Social Enterprise on Donor Behavior." *Journal of Public Policy & Marketing* 31 (1): 142–57.
- Spence, Michael. 1973. "Job Market Signaling." *Quarterly Journal of Economics* 87 (3): 355–74.
- Spiess-Knafl, Wolfgang, and Jessica Aschari-Lincoln. 2015. "Understanding Mechanisms in the Social Investment Market: What Are Venture Philanthropy Funds Financing and How?" *Journal of Sustainable Finance & Investment* 5 (3): 103–20.
- Suárez, David, and Mary Kay Gugerty. 2016. "Funding civil society? Bilateral government support for development NGOs." *VOLUNTAS: International Journal of Voluntary and Nonprofit Organizations* 27(6): 2617–2640.
- Tekula, Rebecca, and Kirsten Andersen. 2019. "The role of government, nonprofit, and private facilitation of the impact investing marketplace." *Public Performance & Management Review* 42 (1): 142–161.
- Terjesen, Siri, Niels Bosma, and Erik Stam. 2016. "Advancing Public Policy for High-Growth, Female, and Social Entrepreneurs." *Public Administration Review* 76 (2): 230–39.
- Thunholm, Peter. 2004. "Decision-making style: habit, style or both?" *Personality and Individual Differences* 36(4): 931–944.

- van den Berg, Marrit, Robert Lensink, and Roselia Servin. 2015. "Loan officers' gender and microfinance repayment rates." *Journal of Development Studies* 51 (9): 1241–1254.
- Varendh-Mansson, Cecilia, Tyler Wry, and Ariane Szafarz. 2020. "Anchors Aweigh? Then Time to Head Upstream: Why We Need to Theorize "Mission" Before "Drift". *Academy of Management Review* 45(1): 230–233.
- Vasudeva, Gurneeta, Lilac Nachum, and Gui-Deng Say. 2018. "A signaling theory of institutional activism: How Norway's sovereign wealth fund investments affect firms' foreign acquisitions." *Academy of Management Journal* 61 (4): 1583-1611.
- Verplanken, Bas. 2018. *The Psychology of Habit*. Cham, Switzerland: Springer.
- Verplanken, Bas, and Jie Sui. 2019. "Habit and identity: Behavioral, cognitive, affective, and motivational facets of an integrated self." *Frontiers in Psychology* 10: 1504.
- Weiss, Andrew. 1995. "Human capital vs. signalling explanations of wages." *Journal of Economic Perspectives* 9 (4): 133–154.
- World Bank. 2002. *Private Sector Development Strategy: Directions for the World Bank Group*. Washington, DC: The World Bank.
- Wry, Tyler, and Eric Yanfei Zhao. 2018. "Taking trade-offs seriously: Examining the contextually contingent relationship between social outreach intensity and financial sustainability in global microfinance." *Organization Science* 29 (3): 507-528.
- Wry, Tyler, J. Adam Cobb, and Howard E. Aldrich. 2013. "More Than a Metaphor: Assessing the Historical Legacy of Resource Dependence and Its Contemporary

Promise as a Theory of Environmental Complexity.” *Academy of Management Annals* 7 (1): 441–88.

WTO (World Trade Organization). 2006. *World Trade Report 2006. Exploring the Links between Subsidies, Trade and the WTO*. Geneva, Switzerland: World Trade Organization.

Zhan, Xueyong, and Shui-Yan Tang. 2016. "Understanding the implications of government ties for nonprofit operations and functions." *Public Administration Review* 76(4): 589–600.

Zott, Christoph, and Quy Nguyen Huy. 2007. “How Entrepreneurs Use Symbolic Management to Acquire Resources.” *Administrative Science Quarterly* 52 (1): 70–105.

FIGURES

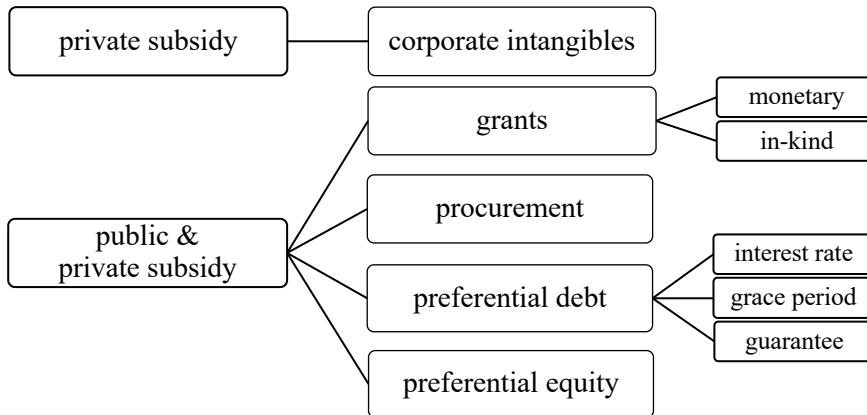


Figure 1. A typology of subsidy instruments

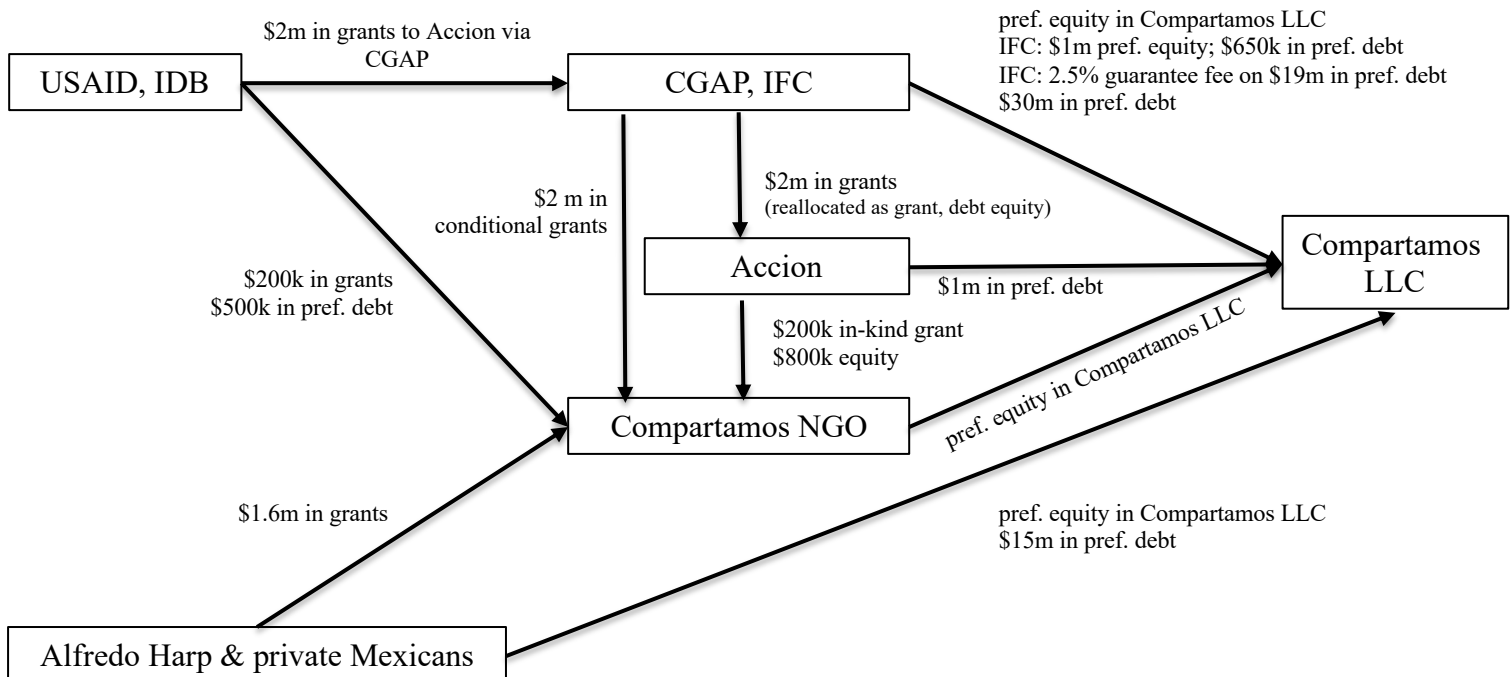


Figure 2. Subsidy flows to Compartamos, based on Ashta and Hudon (2012)

TABLES

Table 1. Grant Typology

Grants	Description
<i>Monetary grants</i>	
Unconditional	The provision of cash to be used at the full discretion of recipients.
Conditional	The provision of cash in return for fulfilling certain behavioral conditions or earmarked for specific functions/activities.
<i>In-kind grants</i>	
Tangible	A contribution of equipment, supplies, or other tangible resources such as office space or computer software.
Intangible	A contribution of voluntary labor, technical assistance, or other intangible resources such as board involvement.

Table 2. Preferential Debt Features

Debt feature	Description
Interest rate	An interest concession is a reduction, compared with market interest rates, in the interest rate charged on a loan.
Grace period	Period of time at the beginning of a loan during which the borrower pays only interest to the lender. After the grace period, the borrower starts repaying the loan principal. For borrowers facing liquidity constraints, a longer grace period is preferable.
Guarantee (security feature in form of collateral)	A promise by one party (the guarantor) to assume the debt obligation of a borrower if the borrower defaults. A guarantee can be limited or unlimited, making the guarantor liable for only a portion or all of the debt.

Table 3. Crowding-In and Crowding-Out Effects of Subsidy Instruments

Subsidy instrument	Proposition	Source-sensitivity	Time-sensitivity
<i>Grants</i>			
Proposition 1	The crowding-in effect of grants is strengthened by using smart subsidy criteria (transparent, rule-bound and time limited).	No	Yes
Proposition 2	The crowding-in effect of in-kind grants is strengthened when delivered by private donors rather than public donors.	Yes	No
<i>Procurement</i>			
Proposition 3	The crowding-out effect of procurement subsidies is strengthened when they are not time limited.	No	Yes
<i>Preferential debt</i>			
Proposition 4	The crowding-in effect of preferential debt is weakened when grace periods are used rather than interest rate subsidies or guarantees.	No	Yes
Proposition 5	The crowding-in effect of guarantees is strengthened when delivered by public donors rather than private donors.	Yes	No
<i>Preferential Equity</i>			
Proposition 6	The crowding-in effect of preferential equity is strengthened when subsidized ownership rights do not extend to commercial funders.	No	No
<i>Cross-instrument</i>			
Proposition 7	The crowding-out effect of smart grants is strengthened once a social enterprise has reached break even.	No	Yes
Proposition 8	The crowding-in effect of preferential debt is strengthened once a social enterprise has reached break even.	No	Yes

Table 4. Compartamos Subsidy Timeline

Year	Financial performance	Event	Source	Type of funder	Type of subsidy	Crowd-in	Conditionalities	Amount (\$000)	
1984		Nonprofit multipurpose Gente Nueva NGO created (mission: social change and poverty alleviation) Microfinance pilot program							
1990			USAID	Public	Grant	Yes	Staff training	50	
1993			IDB	Public	Grant	Yes	Strict reporting	150	
			IDB	Public	Pref. debt	Yes	Near grant terms	500	
1995	OSS (100% Break-even)	Village banking program (Generadoras) separated							
95-98				Banamex (Citicorp subsidiary)	Private	Grant	Yes		300
				Alfredo Harp (Banamex president & family)	Private	Grant	Yes		1,000
				Six other private Mexicans	Private	Grant	Yes		300
1996			CGAP	Public	Grant	Yes	Performance-based (arrears under 10% ; client growth 25% ; ROA target	2,000	
1997	FSS (could survive w/o subsidy)								
2000		Transform to Compartamos LLC	Accion Gateway Fund	Private (financed by public)	Equity	Mixed		20%	
			Profund Int'l (Accion, Calmeadow, Fundes, SIDI – all partly financed by grants)	Private (financed by public)	Equity	Mixed		6%	
			Individual investors	Private	Equity	N/A		33%	
			New financing from USAID	USAID (to Accion)	Public	Concessionary loan	Mixed		1,000
				USAID (to Accion)	Public	Equity (quasi-equity)	Mixed		800
				USAID (to Accion)	Public	Grant	Yes	For urban project	200
2001		Transform to fully licensed bank: Compartamos BANK							
2001		IFC purchase of equity shares in SOFOL	IFC	Public	Equity	No		1,000	
					Pref. debt	No		650	
2002		Issues debt on Mexican bond market							
2004			IFC	Public	Partial Guarantee	Yes		19,000 (fee of 2.5%)	
			Preferential debt (public ag.)	Public				30,000	
			Preferential debt (social inv.)	Private				15,000	
2007		IPO on Mexican stock exchange							