

## **Mihaly Hogue: Some Reflections on Nonprofit Finance Theory – Case of Co-management and Co-production**

This paper makes an attempt to explore some new dimensions of the emerging nonprofit finance theory in light of the co-management and co-production between government and nonprofit organization. Relying mainly on available literature of existing schools that explains economic rationale for nonprofit activities here I would like to add some notes how co-management and co-production may modify thesis rooted in nonprofit theories. Questions like where does co-management and co-production raises more efficient output in case of „earned income” or „government funds” as two of primary fields of financing nonprofit. I would also like to rethink some questions of setting prices, making profits or running at a loss in case of co-management and co-production. How co-management and co-production effect costs and income of nonprofits? Does co-management and co-production have a „crowding-out” effect between different financial resources? Answers are to be approached via examples and cases from Hungary.

### ***The emergence of nonprofit financial theory***

Since the mid-sixties in the development of welfare state, a new paradigm has emerged: the third or non-profit sector. The increasing number and forms of nonprofit organizations and their increasing social and economic importance have set forward questions to which scientific researches had to answer. The first reaction had come from economics.

Within economic theories one track is dealing mainly with the economic roles of nonprofit organizations, the other is with the behaviors of these organizations. The first track could further be classified into approaches from demand or from supply side explanations. Beside pure economic approaches many of them reflects financial issues as well, but those are not considered as independent, autonomous discipline. Finance is tackled within the terminology of economics. This is the reason why theoretical approaches to nonprofit finance have got more attention from scholars later in the last fifteen years.

Two streams of theoretical approaches can be distinguished in the development of nonprofit finance theory. The first relies mainly on economic theories approaching the role and behavior of a nonprofit organization in the economy. This line applies the logic and techniques of micro economics and/or public economics/finance. The second stream focuses on the managerial questions of nonprofit finance, fundraising, budgeting, accounting, debt management, asset management etc. Here I pay attention to the first stream.

Searching for a *normative theory of nonprofit finance* Young (2006) points out that „any theory of nonprofit finance must account for three basic issues – financing of current operations, financing of long term capital needs and the balance or mix among different sources of income for these purposes.”<sup>1</sup> It is clear even from this assertion

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<sup>1</sup> Young (2006) pp. 339.

that the theory focuses on the *activities at (nonprofit) organizational level* centering on monetary questions. (Non-monetary issues could be part of the analysis if there is a chance to express them in money term. The solutions are similar to those applied in public finance for example valuing non-monetary phenomena in cost-benefit analysis.)

Financing current operations aims to find the ways how current operating costs are covered and how objectives are achieved in the short term. Capital financing seeks to ensure long term 'survival' of the nonprofit organization by establishing capital resources. Balancing of different sources of income relates issues like ensuring solvency, risk management and administrative feasibility.

*What theories help to understand and to develop the above issues?*

#### 1. Demand theories of the neoclassical economics

- The *market failure* and the *government failure* theories explain why government and philanthropic financing, or profits from sales, may be needed to produce some nonprofit services; and why government sometimes provides inadequate support, or chooses to support nonprofits rather than provide services directly.<sup>2</sup>

- *Contract failure theory* explains how nonprofits can compete efficiently in the marketplace where trust is important<sup>3</sup>,

- *Theory of customer control*, that also relates to market failures, namely to monopoly market. The theory (Ben-Ner, 1986) states that an important objective of

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<sup>2</sup> The *market failure* and the *government failure* theories (public goods theory or heterogeneity theory) (Weisbrod, 1975; 1977 ;) states that the nonprofit organizations provide public goods and services in private financing in economies where the market and the public sector have already had distinctive roles. The existence of the nonprofit sector is a definite answer by the unsatisfied customers to the failures of both the market and the government. From this theory it could be derived that the absolute and relative size of the nonprofit sector to the government sector are determined by the number and proportion of those customers whose demand the government is not able to fulfill. The size of the unsatisfied customer group depends on demand for public goods at the level of heterogeneity of the existing tax system. (An excellent summary of literature on government failure and market failure approaches is given by Dollery and Wallis, 2002.)

<sup>3</sup> *Contract failure theory (theory of trust)* (Hansmann, 1980) is widely accepted in the literature on nonprofit sector. The central point is that the form of nonprofit organization is capable to give solution to the failure of contractual relations as a market failure due to the asymmetric information between market actors. The customers trust more in nonprofit organizations because nonprofit organizations differ from private, for-profit ones in many aspects, like missions, motives, incentives, etc., etc. This theory assumes also that the nonprofit sector provides mainly public goods and services. It strongly emphasizes common characteristics of nonprofit organization like nondistribution constrains on profit and the facts that the sector includes very different forms of organizations.

establishing nonprofit organization is to ensure customer control over producers and service providers.

## 2. The supply theories

According to the supply economic theories the goods and services provided by nonprofit organizations can be considered as quasi-public goods since they satisfy public and private needs at the same time. Thus on the contrary to the demand theories – where nonprofit organizations are the alternatives for for-profit ones – here nonprofit organizations compete not with the market sector but with the government sector. This influences the composition of revenues as well as market or non-market behaviors in nonprofit.<sup>4</sup>

The economic theories have defined the nonprofit sector as institutions emerged outside the government for providing public goods. The nonprofit sector has a supplementary role for providing public goods, gives alternatives for private goods provided by the market sector that are substituted for collective goods. Nonprofit provision of goods and services preceded the government's supply of public goods.

## 2. Subsidy theories

Nonprofit organizations are unusual in the manner in which they finance themselves. They do not rely entirely on sales of goods and services, and they do not have powers of taxation through which they can command public support. Nonprofits receive significantly more support from voluntary gifts and grants than other types of organizations. The activities of nonprofit organizations heavily depend on different external resources, direct and indirect grants and subsidies from government, corporations and individuals, tax preferences, gratis property use, low rental fee, etc. Question is whether the expanding subsidies are consequences or reasons of the increased number of nonprofit organizations. Financing through donations (for example voluntary price discrimination) can be considered as correction tool for special market failures characterizing different industries.

## 3. Organization theories

These theories suggest that nonprofits require independent forms of income to maintain mission focus, hedge against risk and pursue innovation, and that multiple sources of income may enhance flexibility to experiment, innovate and adjust in response to changes and complexity in the environment.

## 4. Decision-making theory

The theory suggests that establishing and managing nonprofit organizations are the results of conscious, voluntary decisions and of choices between alternatives of social

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<sup>4</sup> The basic thesis of the theory (James, 1987) that the market and government failures are necessary but not sufficient conditions to explain the differences between nonprofit forms and country specifics. Empirical analyses have shown that the size and structure of nonprofit organizations significantly deviate across countries and the theories did not answer to it. The supply side explanation of development of the nonprofit organization seeks for the motivations of the founders of these organizations that are: for -profit in disguise, social prestige, political influence, ideology.

costs and benefits. Experts consider consciousness and volunteerism as the most important characteristics of the nonprofit sector.

From the theory it can be directly derived that an analysis is needed focusing on the questions: who make decisions, what are their motivations and what sort of decision-making mechanism is applied. In order to understand decision-making on revenue structure or to analyze fund-raising activities of nonprofit organizations we need to know the types of financial decisions.

In Hungary five big groups of decision-making mechanism can be distinguished that have dominant roles in nonprofit financing (Kuti, 2003):

- distribution mechanisms codified in law
- redistribution decisions in the public and private sector
- participatory and contractual decisions
- customer's decisions
- mechanism of the money market

### ***Two issues of nonprofit financial theory (at level or nonprofit organization)***

#### *1. Earned income*<sup>5</sup>

The term “earned income”, defined here is as revenue from sales of goods and services in the private market.

Quoting Young (2004b) first, we need to ask about the kinds of goods and services it is appropriate for nonprofit organizations to sell in the market. The answer is manifold:

- a) There are certain types of goods and services which theory argues may be more efficiently provided, from a social point of view, by nonprofits than by for-profit businesses. This statement is based on different concepts:
- “contract failure”, example, higher education, child care, nursing home
  - “mixed public/private goods”, example, job training, museums, performing arts

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<sup>5</sup> When exploring the financial situation of Hungarian NGOs, we have to list the potential resources they have at the moment. Generally speaking, there are six types of resources available: state funding (central budget, national programs, EU Structural Funds, etc.), local authorities (local budgets, local public foundations, etc.), private funding (1%, other private donations from people, volunteering, bequests, etc.), company donation (sponsoring, in kind contributions, etc.), foreign resources (foreign government resources, foreign private foundations, companies, etc.), internal income (service fees, membership fees, entrepreneurial income, etc.). We can also identify important tendencies in the financial situation of the Hungarian NGO sector. Between 1993 and 2006 nominally the income level grew 750%, but in real prices the growth is only 78%. The structure of income also went through severe changes. While in 1993 most income came from entrepreneurial activities (32%) and private donations (23%) whereas state subsidies accounted for 16,4%, in 2006 state subsidies constituted the biggest source of income (42,3%) for these organizations. (Arató, 2009)

b) There are other instances where the nonprofit may compete in the market because of cost advantages or unique product characteristics. The concepts underlying these are:

- “economies of scope” or “complementarities”, example: museum providing additional services like wedding, parking
- “economy of scale”, example: hospital with own laundry offering external services
- “special reputation” (monopoly), example: selling university T-shirt, special knowledge or expertise in science

(Note: tax preferences, volunteer free labor and charitable contributions do not represent real cost advantages. These are “not a reason per se for offering a given good or service for sale even if such advantages would allow the nonprofit to compete successfully with commercial suppliers.”<sup>6</sup>)

c) There are services for which the nonprofit has no particular competitive or social efficiency advantages, but which provide market-based vehicles for pursuing social missions and producing social benefits. The basic concept is:

- “social enterprise”<sup>7</sup> types of goods and services, example business to train and employ disadvantaged workers, grocery shops for poor (in Hungary).

Second, we need to ask about setting prices: making profits (maximum or lower), break even or running at a loss. The alternatives (not exclusively) are:

- in case of contract failure, no reason to make profit but also no reason to make loss
- in case of private services with externalities it is reasonable to run with losses but compensation is needed
- in case of real competitive advantage it is feasible to generate net income
- in case of utilizing market enterprise there are several options: profit not necessary at maximum level, break even or losses because of generating social benefits but compensation is also expected

## *2. Government funding*

Young (2004a) raises the question: under what circumstances it makes sense for a nonprofit organization to seek and accept government funding, and where that funding fits into its overall revenue portfolio. The basic considerations:

- if the social mission of nonprofit organization is consistent with the government program, government funding can not be problematic, example: a nonprofit that provides parenting education financed by modest fees and some donations might be able to do much more with a government subsidy

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<sup>6</sup> Young, 2004b, p. 2.

<sup>7</sup> Broadly defined as the use of nongovernmental, market-based approaches to address social issues, social enterprise provides a “business” source of revenue for many types of socially-oriented organizations and activities. An excellent overview on different approaches to “social enterprise” is given by Kerlin (2006).

- nonprofits whose missions address mainly redistribution issues (health or social services, housing for the homeless, etc.) are often well advised to seek government funding
- if funding has too bureaucratic character, the efficiency of the program can easily decrease
- “crowding out”, that is acceptance of government funding may reduce charitable contributions
- volatility of government funding over time can be problematic (but other sources can even be more volatile).

### ***Towards co-management and co-production***

Since the mid-eighties interpretation of the roles of nonprofit sector has been linked to a search for the ways out of the crises of the welfare state. One of the main characteristics of this era is the privatization of public services in the health care, education and social service sectors. Prior to it nonprofit was considered as one of the dominant service providers in these sectors relying on direct or indirect subsidies and outsourcing mechanisms. Revenue declines from government funds have revealed the strong financial dependence of the nonprofit organizations from the government. Several studies documented this financial dependence of the nonprofits. Scholars analyzed the consequences of the decrease of budgetary resources and explored the theoretical relations of the experiences (Dimaggio and Anheier, 1990).

A comprehensive theoretical approach – *theory of voluntary failure (or interdependency)*<sup>8</sup> has been evolved to answer the problems.

In the development of welfare state the nineties was about to refine the role, functions and actors of the government. A theoretical modeling of this process has appeared in the concepts of welfare-mix and welfare pluralism. Scholars of social policy, sociology and political science have analyzed the interrelations of already four sectors (government – market – nonprofit – household) – the questions of *welfare pluralism* - applying also the results of economic approaches.<sup>9</sup> Another outstanding development

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<sup>8</sup> The theory of interdependency (or voluntary failure) (Salamon, 1987) is aimed to explain and analyze the paradox of why, how and when partner relationship is formulated between government and nonprofit organization. The system of relations is called "*third party government*" that assumes that the private and the nonprofit sector will typically be the first line of response to perceived 'market failures', and that government will only be called on only as the voluntary response proves insufficient. (A clear note is given on the concept and literature of voluntary failure by Dollery and Wallis, 2001.)

<sup>9</sup> The concept of welfare pluralism (Evers and Olk, 1996) assumes that the individual and collective welfare depend not merely on the available welfare resources (social capital, goods and services, time) but on preferences and abilities needed to mobilize these resources. Improving welfare needs activities in two different - macro and micro - dimensions. At micro level the individual capacities and action strategies should be linked to the logic and selectivity of organizations producing welfare goods. At macro

of the decade is the theory of *social origins of civil society*, which wants to give answer to the differences across countries in the evolution of nonprofit sector and to explore types of cooperation between the government and the nonprofit sector.<sup>10</sup>

Jumping to recent contributions of scholars, Brandsen and Pestoff (2006) on different modes of cooperation between government and third sector it should be quoted: „All refer to a type of cooperation in which the third sector has a direct influence on the nature of the service. ...

- *Co-governance* refers to an arrangement, in which the third sector participates in the planning and delivery of public services.
- *Co-management* refers to an arrangement, in which third sector organizations produce services in collaboration with the state.
- *Co-production*, in the restricted use of the term, refers to an arrangement where citizens produce their own services at least in part. This is a specific interpretation of user involvement, although there are of course various other types.”<sup>11</sup>

Analyzing nonprofit finance in case of co-management is more difficult than in case of an independent decision of a nonprofit organization. And even it is more difficult to do in case of co-production. Now I am trying to put some reflections on two issues mentioned before – earned income and government funding.

In case of co-management and co-production the explanation of revenue flows from selling goods or services could be very similar to the situation of the level or nonprofit organization. Deviations can be explored by analyzing the different interests of the partners involved. Here I can refer to the Hungarian experience where in most cases co-management and/or can be established between local governments and nonprofit organizations when local government

- is a founder or co-founder of the nonprofit,
- is a contracting partner,
- is a financial sponsor, grantor
- is a member (mainly in municipal associations)
- is a grantee or beneficiary of nonprofit or volunteer activity
- is a cooperating partner in decisions related to local community (Kuti, 1998).

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level a new combination of the four sectors’ activities would lead to increased welfare by ensuring chances for control to everybody. (Bartal (2004) gives a nice overview on the concept.)

<sup>10</sup> The theory (Salamon and Anheir, 1996) points out that the choice in the demand for public services between sectors depends not merely on the free decisions of the individual customer, but it is determined by historical antecedents. The nonprofit organizations are embedded to the social and economic structures that are different country by country.

<sup>11</sup> Brandsen – Pestoff, 2006, p.4.

In each of these categories co-management and/or co-production may be established provided individuals participating in service provision are members of the nonprofit organization or they step into contact with local government via a nonprofit organization or volunteer group. Of course these represent different roles and missions, different decision-making powers, different financial participations and different responsibilities for local government, for nonprofit organization and for individuals. For example, when the local government is the founder of the nonprofit organization it keeps the rights of defining mission, of exercising political and economic control, of providing initial financial resources and assets of the nonprofit in question. The above functions of a local government are quite „softer” in case of being a member in a nonprofit and those functions can even be very weak in case of being beneficiary.

Co-management is more feasible if there is a contract between local government and nonprofit. (Here I exclude the „contracting out” option since it does represent a softer co-operation.) If the aim of the contract is providing goods or services (mainly public services) the two partners should have equal rights in principle for establishing and running the activities under this partnership. Since our focus is revenues from sale of goods and services here the two partners’ policies toward opportunities for earned income can be the followings:

- If the basic objective of the partnership is a simple service provision the local government’s interest is to ensure that the internal efficiency and the allocation efficiency of the service would be improved and at the same time a certain type of equity would be achieved. The local government should care about the conditions for „trade off” between efficiency and equity. It requires political decision.
- The nonprofit policy has also considered equity questions derived from its mission but in most cases it has low influence on its cost and price policy. Instead nonprofit seeks to exploit available resources that determine internal efficiency concerning both its real cost advantages and external resources.
- Depending on the existence and levels of competitiveness of the nonprofit in the marketplace described above the results of government-nonprofit ’joint venture’ could be characterized in the same way with one exception.
- That is when the ’joint venture’ is financed from earned revenue and from (local) government funds, the minimum pricing requirement is break even unless private donation is available to keep service level in long run.

Co-production provides services where measuring earned income is a question of opportunity cost. Pestoff (2004) gives an excellent overview of professionals’ contribution to the question of productivity and cost efficiency of coproduction programs. He refers among others to<sup>12</sup>

- Brudney (1983) who concludes that co-production can promote cost efficiency, but normally fails to realize cost effectiveness, in particular when large mass-volunteer programs are put into place to replace a sizable proportion of the public workforce.

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<sup>12</sup> Pestoff (2004), p. 5.

- Warren et al. (1982) who maintain that co-production can lead to cost reductions, higher service quality and expanded opportunities for citizens to participate in decisions concerning public services. The latter can result in greater satisfaction and support for public services. Co-production also becomes an important means of enhancing both the quality and quantity of public services.

If the above findings are considered as evidences, from financial point of view the decrease of the price of the service would be expected. This would be the explicit benefit for the customer of the service, including „co-producers”. However, coproduction certainly provides goods or services which have only „internal” market, pricing is becoming less emphasized.

As far as (local) government funding concerns it can be related more to the situations when local government is a founder or co-founder of a nonprofit organizations, when local government „only” a financial sponsor for activities of nonprofit organizations or individuals, or when local government is a member of the nonprofit organization. The motives for granting money could be different according to the above positions.

Co-management is more feasible when the local government acts as a member of a nonprofit organization. In that case the members - having equal rights in principle – can decide on forming 'joint' programs financed not only from earned revenues but even from tax money set aside in the local budget. The impacts of co-management on the theoretical considerations listed in case of organizational level would be the followings:

- Local government funding is appropriate since „membership” status assumes that the social mission of nonprofit organization is consistent with the local government program
- It is still feasible if nonprofits whose missions address mainly redistribution issues (health or social services, housing for the homeless, etc.) are often well advised to seek government funding (see example below)
- Co-management can help to reduce administrative burdens on the program since local administrative staff could be substituted for volunteers. As a consequence cost could be reduced, quantity of the service could be increased, and all in all, efficiency and effectiveness could also be improved.
- “Crowding out” is less expected since the involvement of local fund is per se part of the program financing
- Volatility of funding over time is expectedly decreasing if this form of co-management operates in longer run.

Financing co-production activities from tax-money is also more appropriate when the local government is a member or case-by-case partner of nonprofit groups or individuals. This would also have similar impacts on financial interests of the partners involved in the provision of the service. Addition to the case of co-management it is expected that individuals involved have got more interests to increase quality of the service, since they are also benefited from the program. Since these benefits are primarily not financial ones, their objective is to run successful and sustainable program.

Examples:

1. The Maltese Charitable Service and the local government of city Győr in Hungary.

The Maltese Charitable Service has operated daytime care of disabled for ages. The municipal government of Győr has also had similar responsibility, but it lacks of capacity for meeting its obligation. As a result many parents had to give up jobs in order to care about their kids. The city management has contacted the Maltese Charitable Service seeking for new capacities of care. They concluded with a contract on co-management. Since the care has already been run by the Maltese Charitable Service no new institutions had to be established. In the contract they agreed on the way of co-financing. The Service receives the per capita grant from the central government budget – that is guaranteed by law – and the extra costs are paid from the local budget. The contract brought no financial burden on the Maltese Charitable Service, but it required a certain reshaping of the administration and the organization.

The local government had also benefited since no investment was needed; no new staff had to be recruited for professional care and also for administration. Cost has been saved, output has been increased. Beside this internal efficiency improvement, the allocation efficiency has also improved, since more parents were able to send disabled kids to the center for daycare. A special advantage of the co-management has been the use of professional skill on the side of the Maltese Charitable Service.

The cooperation between the Service and the local government enjoy other benefits as well. The Maltese Charitable Service harmonizes its charitable activities with the local public issues. Several volunteers from the service are members of local committees related to social services.

2. St. Cyril and Method Foundation and the local government of city Győr in Hungary.

Prior to the cooperation with the local government of city Győr, St. Cyril and Method Foundation had run a Club for Elderly. However the local government did not give financial support for this activity because in this service market had already been enough service providers. However the service for temporary family housing, shelter had not been established in the city. The Foundation had already started investing into this service. Searching for suppliers of temporary shelter the city managers signed a contract with the Foundation to provide this service extending the investment to meet the city demand, too.

The financial agreement is similar to the above example. Government grant per capita from central budget covers part of the cost and the local government covers the rest of the operating costs. In long run the investment by the Foundation serves public interests, the government funding of operation provides stable financial position.

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