SOME REFLECTIONS ON NONPROFIT FINANCE THEORY – CASE OF CO-MANAGEMENT AND CO-PRODUCTION II.

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ABSTRACT: *This paper is the author's second 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. In the first paper – presented at EGPA Annual Conference in Malta in 2009 - questions where does co-management and co-production raises more efficient output in case of „earned income" or „government funds" were visited. This time I would like to explore two other fields of nonprofit revenue: donation (corporate or individual grants) and borrowing. I would also like to rethink again 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.*

KEYWORDS: *nonprofit finance, co-management, co-production, nonprofit organization, donation, borrowing.*

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*Short overview of the previous article (Part I)***

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.

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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.”[1] It is clear even from this assertion 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. Balancing of different sources of income relates issues like ensuring solvency, risk management and administrative feasibility.

Several theories help to understand and develop the above issues: *market failure* and *government failure theories*, *contract failure theory, theory of customer control, supply theories*, *subsidy theories, organization theories*, *decision-making theory.* These theories helped us to analyze two issues in nonprofit finance at level of organization: earned income and government fund. As far as earned income concerns it could be distinguished what kinds of goods and services are appropriate for nonprofit organizations to sell in the market. As for government fund it could be answered questions 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.

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. New theories have been evolved to answer the challenges: *theory of voluntary failure (or interdependency theory), concept of welfare pluralism*, *theory of social origins of civil society.*

For an outstanding recent contribution by 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.”[2]

Analyzing nonprofit finance in case of co-management is more feasible if there is a contract between local government and nonprofit. 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. If the basic

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[1] Young (2006) pp. 339.

[2] Brandsen – Pestoff, 2006, p.4.

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 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.

Co-production provides services where measuring earned income is a question of opportunity cost. Co-production can promote cost efficiency and can lead to greater satisfaction and support for public services by citizens who participate in service provision. 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 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. "Crowding out" is less expected since the involvement of local fund is per se part of the program financing.

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. 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.

Now I am trying to put some reflections on two other issues – donation or individual grants and borrowings.

Two issues of nonprofit finance theory (at level of nonprofit organization)

1. Donation[3]

The term "donation", defined here is as revenue from individuals or corporations supporting nonprofit organizations. It differs from government grant mainly because government distributes public money and he is accountable for it while distributing privately owned assets is the discretion of individuals and corporations. It can even be

[3] When exploring the financial situation of the 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+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.). (Arató, 2009) The structure of revenue is shown in Annex.

said for the relatively unique *"percentage" philanthropy*[4] when donation is derived from tax revenue but the decision is individual within legal restrictions.

First we need to ask what the main motives for donations are. Nonprofit organizations 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 significant support from voluntary donation. Financing through donations (for example voluntary price discrimination, implicit loans or optional demand) can be considered as correction tool for special market failures characterizing different industries.

Kuti (2008) has described three different types of motives of donation:

- charity, social responsibility,
- relationship, participation,
- private interest and benefit.

These motives are mirrored in *economic approaches* explaining voluntary giving.

Private interest and benefit motives can often induce individual donation in case of *"positive externalities"*. It can occur when a service is under-produced in the market because of relatively low price or the service is maintained despite of low demand, so voluntary contribution (voluntary price discrimination or optional demand) can help to raise the quantity and quality of the service. As a result, nonprofit can produce a maximum level of social benefit.

Participation motive (together with private interest and benefit) is also mirrored in case of certain *"public good"* that should be provided by government. If the national public service (for example primary state education) does not satisfy the special need of people with different preferences nonprofits can offer their service to supplement government supply. Parents of the schoolchildren feel more or less obliged to help the nonprofit organization which provides their children with services.

[4] Hungary was the first country who introduced 1% percent designation in 1997 that was extended to 1+1% in 1998. The percentage mechanism enables individual taxpayers – natural persons – to designate 1% of their paid income taxes to a qualifying NGO and another 1% to a church (in addition to NGOs, there is also a list of budgetary institutions, and as an alternative to a church, a special budgetary priority objective is named each year). Hungary was followed by Slovakia in 2002, then by Poland, which introduced a 1% system in 2004; Lithuania, which launched a 2% system in 2004; and Romania, where a 1% law came into effect in 2005. Furthermore, the mechanism has many other applications: for example, the idea has also been adopted at local government level in Hungary, where several town councils allow taxpayers to allocate a percentage of their local tax to one of a pre-selected range of beneficiaries. An example outside Europe is from the town of Ichikawa in Japan where under a system first implemented in tax year 2005, the town's inhabitants are now able to give 1% of their local tax to projects run by local NGOs and community groups. (Gerencsér – Oprics, 2007)
This mechanism does have certain advantages for co-management as well. Specifically, it has proven to be a good resource for local and smaller NGOs, because it is easier for them to mobilize local support (although in terms of the actual amount of funds it has a bigger impact on the larger NGOs who champion popular issues such as children's care or animal shelters). It creates competition among NGOs, thus contributing to increased professionalism, better communications and improved image. Most importantly this was the first and major reason why NGOs in Hungary started to communicate with their constituencies rather than with the government grant departments. As a result NGOs have become more embedded in their local communities. In addition, the mechanism gives the possibility to taxpayers to decide on how a certain percentage of their tax money is spent (decentralizing and de-politicizing the decision making process), increases awareness about the importance of civil society and sends signals about needs they find important to be supported. (Hadzi-Miceva, 2008)

Other examples the foundations of the hospitals, some social care providers, and some nonprofit organizations specialized in rehabilitation and recreation services. They can attract support from individual whose decision is based on their direct interest in improving the quality and/or increasing the quantity of services used by them or by their relatives.

Charity and social responsibility are considered to be the most important motives for donating. The willingness to help, the solidarity toward the needy, and the responsibility for the general well-being of the community used not to be explained by economic factors. However, in many cases social responsibility is coupled or overridden by the individual donor's close relationships with the supported voluntary organizations and the participation in their work motivates the selection of beneficiaries. Philanthropy "is a matter not just of moral capital in the form of generosity. It is perhaps more a matter of associational capital in the form of social networks of invitation and obligation"[5]

2. Borrowing

Like businesses, nonprofit organizations sometimes need cash in the form of a loan to operate their programs effectively. Loans can be a tool that can help their nonprofit grow and succeed. Borrowing is needed for several reasons. Among others the need for *working capital, for capital purchases, for purchase or renovate building, for capital campaign* could be strong arguments to borrow. Borrowing is also an opportunity to *start or expand a program, to established endowment, or consolidate existing debt.*

The benefits of borrowing are easy to understand: access to current cash allows one to spend, and in the nonprofit setting spending it is associated with increased social welfare. Since the nonprofit organization is limited to three financing alternatives including *free cash, increased fund-raising (including capital campaigns) and debt*, the decision of whether or not to invest in a project and how to finance that project are jointly determined. Debt will be issued only if the cost of doing so is not greater than the benefit provided by the new project and the nonprofit has exhausted other forms of lower financing.

Some people believe that borrowing is a sign of dire trouble – proof that the board and management have done something wrong. The truth is that managing cash flow, making loan and interest payments and planning for stable operations are all part of successfully managing an organization.

In many countries nonprofits are sophisticated users of different debt instruments such as *bank loans, bonds and mortgages, tax-exempt leases*[6]. As mentioned above the main objective in nonprofit for searching external money and

[5] Schervish and Havens, 1997, p. 257.

[6] It is not the case in Hungary. Less then three percent of the nonprofits' total revenue is derived from borrowings. Most of the nonprofit organizations are not able to borrow money for operational or investment purposes. The general reason is that they do not own suitable assets to guarantee the repayment of the potential loans.

undertaking debt is capital investment.[7] (Note: income from investment on the other edge can be considered as a form of own revenue, like service fees.)

Towards co-management and co-production

In Hungary terms co-management and co-production have not been planted yet in nonprofit literature. Instead, cooperation between (local) government and nonprofit is described by terms of "joint performance with non-government organizations operating locally" or "direct involvement of the population" are used. Although cooperation between nonprofit and local government has old tradition it is still rarely used way to organize service provision.

In case of co-management and co-production the explanation of donation could be approached via similarities to the situation of the level or nonprofit organization. Deviations can be explored by analyzing the different interests of the partners involved. Here again I can refer to the Hungarian experience where in most cases co-management and/or co-production 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).

In each of these categories co-management and/or co-production may be established provided individuals donating certain assets to a nonprofit organization 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 week in case of being beneficiary.

Private donators prefer supporting nonprofit organizations grew out of the local society, or the organizations well known by the citizens and they also have the technical skills, therefore they can have information about the local market. In cases when

[7] In most countries in the CEE region, there are no special rules relating to endowments or investing, including investments abroad. As legal entities, NPOs are subject to the general regulatory framework for investments in the given country. In Hungary, for example, any investment is permitted, but only investments in government bonds may be tax exempt. Countries in the region have imposed relatively few restrictions on how property may generally be invested. As noted above, foundations are sometimes required to maintain a minimum amount of assets, where the minimum is either a fixed amount or an amount sufficient for accomplishing the foundation's purposes. These restrictions may require foundations to invest conservatively to avoid falling below the relevant threshold. Hungarian law specifically states that economic activities must not jeopardize a foundation's purposes.

donation is associated with certain demand for customer control nonprofit organizations can undertake the protection of donator's interest.

However, many donators are not clear about the fact, that nonprofit organizations may pay high salaries, or may spend the granted money on expensive capital goods. Furthermore, donators do not consider the possibility of their donation funding the sometimes high administration costs of the organization.

Another threat in cooperation is the technical control over voluntary organized activities. This is the responsibility of the local government. If the bulk of the operation is performed by specific groups of citizens damage might occur even with the best will.

Donation is often related to politics. Local nonprofit organizations may belong to a political group or party and this leads to a belief that voluntary giving causes over politicized local environment and cooperation is established only for collecting votes, money, or achieving influence. Therefore, the resistance of the population should always be taken into account when cooperation agreements are entered into with the different organizations.

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 donation the two partners' policies toward opportunities for voluntary giving 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. This decision can strongly influenced by individual or corporate donations. For example, if the city hall allows taxpayers to allocate a percentage of their local tax to one of a pre-selected range of beneficiaries among them to those who are contracted with the local government the service cost could be decreased. As a result, more efficient service operation and greater chance for equity issues are achieved.
- 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. Charitable donations can help on it, as well.
- 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 in principle could also be generated by individual donation. Persons who are active participants of nonprofit activity are more willing to contribute financial or in kind support in order to be benefited from the results. For example, people with aim of keeping neighborhood clean are willing to donate nonprofits engaged in voluntary environmental works. Parents whose children are actively participate in extra school programs like learning music, playing football, etc. provided by nonprofits are convinced that they contribution will provide benefits for the entire family.

Since voluntary giving is one of the major revenue for many nonprofits it seems to have significant influences on the concentration of financial resources among organizations. One is a well-known trend – at least in Hungary – that is financing nonprofit has only one channel: individual donation. The other impact can be described by applying the “flypaper effect” used to explain certain aspects of local government financial policy. It simply says that money sticks where more money is transferred before. In case of nonprofit finance we would argue that well-endowed and even government sponsored organizations have more chance to attract individual donation. Reasons are manifold: more effective marketing opportunities, more than just local scope of activities, a regulated system of receiving government or foreign (EU) sources that requires matching fund, people’s trust in organizations having a “brand”. All of these have significant impacts on co-management issues, as well.

Borrowings can also have some influence on co-management and co-production. In this case the questions arise:

- the nonprofit who borrowed money from external actors under what circumstances is able to manage his debt?
- the (local) government who is willing to cooperate under what circumstances is undertaking a part of debt service?
- the individual who participates in nonprofit activities under what circumstances he is actively contributing?

Answers could be very different. A positive logic might be the following.

Assume that there is a contract between local government and nonprofit to provide a particular service in the settlements. In order to ensure an initial capital for the service the nonprofit takes bank loans to launch the program. The local government is aware of the fact of borrowing, but he trusts in effective nonprofit performance or even he more, he gives guarantee over the debt service. If the service produces enough revenue for covering costs of debt service and the co-management ensures a probably non-measurable social benefit for the community the deal is acceptable for both partners. The local government saves public money the nonprofit is benefited by “advanced” cash in form of loan.

As for individual concerns, if he trusts in effective nonprofit performance and in future benefits, he is willing to contribute additional sources (donation or voluntary work) to the planned service. In both cases motives would lead to a pricing policy of break even or a slight profit margin.

Of course in order to gain trust from government or from individuals nonprofit should hold and prove good image of performance on its previous activities.

Annex

Revenue structure of nonprofit organizations in Hungary (%)

Revenue sources	1996	2006
Central government grant (unconditional)	2,0	6,5
Central government grant (conditional)	12,0	20,4
Grant from central earmarked funds	5,0	6,2
Grant from National Civil Fund	x	0,9
Grant from 1% of personal income tax*	x	0,8
VAT reimbursement	x	0,1
Total from central government	*19,0*	*35,1*
Local government grant (unconditional)	0,3	0,7
Local government grant (conditional)	3,0	6,2
Total from local government	*3,3*	*6,9*
Grant from other budgetary institutions	x	0,1
Transfer from local business tax	x	0,1
Total from Government	***22,3***	***42,2***
Corporate donation	7,0	4,6
Individual donation	2,5	1,9
Donation from foreign sources	8,0	4,3
Donation from nonprofit organizations	3,7	1,5
Total private donation	***21,2***	***12,3***
Membership fees individuals	3,7	2,1
Membership fees legal persons	5,8	2,1
Revenue from core activity (service fee I.)	19,0	22,1
Core activity total revenue	***28,5***	***26,3***
Revenue from business activity (service fee II.)	17,0	11,9
Revenue from rental fee	x	1,0
Interest revenue	5,9	1,2
Revenue from financial operations	4,4	2,3
Total business revenue	***27,3***	***16,4***
Revenue from borrowings	0,6	0,8
Other revenue	0,1	0,0
Grandtotal	***100***	***100***

Source: Central Statistical Office

*Data suggest that the 1% system has not 'crowded out' private donations, or reduced their importance.

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