

# **How nonprofit and economy can co-exist: A cooperative perspective\***

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## **Abstract**

Challenging the economic neo-classical discourse that links the accumulation of profit to its distribution, implies disentangling the two notions and admitting the possibility, for an organization, to distribute surpluses while maintaining its nonprofit character. Likewise, it implies belying the alleged incompatibility between the notion of nonprofit and economic entrepreneurship. This suggests that the notions of non-profitness and economic entrepreneurship can co-exist. It is argued that asserting the non-profitness of cooperatives and related social economy organisations, might help to distinguish between nonprofits that develop in the context of the economic mainstream without challenging it, on the one hand, and nonprofits that question the economic mainstream as a *fait accompli* and aim to achieve an alternative to it, on the other hand.

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**Nonprofit, the non-distribution constraint and cooperatives**

Cooperatives' 'nonprofitness' is traditionally based upon such tenets as the indivisibility of the common reserves, the disinterested process of dissolution and the proportionality of member transactions as the criterion of surplus distribution – if any. In economic theory, however, "nonprofits" are commonly designated as organizations subject to the "nondistribution constraint", meaning that they are forbidden from distributing any part of the organization's surplus to those who control the organization (members, directors and officers). The very fact that cooperatives are not subject to the "non-distribution constraint" and may, if they wish, distribute to their members part of their net earnings in the form of patronage dividends, is at the origin of a controversial issue in the literature. In the words of Hansmann (1996, pp.17-18):

A well-drafted nonprofit corporation statute imposes this 'nondistribution constraint' on any organization formed under the statute, and hence prohibits the formation, as a nonprofit corporation, of any form of cooperative and of any other form of owned enterprise.

Excluding cooperatives from the nonprofits makes no particular problem where there is a tendency to see cooperatives as just 'another form of firm'. A similar approach informed the authors of the Johns Hopkins University research on the Third Sector (Salamon

and Anheier, 1994) when it was decided to exclude cooperatives from the study under the pretext that they 'distribute profits'.

Equating for-profit organizations with profit distribution is all-too-natural by neo-classical economic thinking. Hence, its logical reverse: nonprofit-cum-nondistribution constraint. Cooperatives, though, tend to evade this dichotomic view. They claim to be, at the same time, economic enterprises *and* nonprofit organizations. The point is often overlooked that the option of surplus distribution does not necessarily deprive cooperatives of their nonprofit nature. In fact, by cooperative standards, distribution is done - if at all - in proportion to the members' patronage, regardless of the amount and kind of share capital contributed to the cooperative. The process is thus unrelated to capital profit considerations

Excluding cooperatives from nonprofits, thus relieving them from the nondistribution constraint, could hypothetically lead to the proposition that *since all nonprofits are prohibited from distributing profits and all the components of the social economy are nonprofits, so all the components of the social economy are prohibited from distributing profit*, an obvious absurdity. .

Such a logical construct is flawless from the deductive point of view yet is invalid, as it fails to take account of the situations offered by cooperatives. Any inductive analysis would easily show that cooperatives, can distribute 'profits' and still remain nonprofits.

### **Continuation of profit orientation**

A **continuous**, rather than dichotomous, approach to the profit/nonprofit issue can be made from diverse perspectives, according to major component dimensions identified. Three such perspectives recently tested are based on: 1) the distribution of surplus; 2) the remuneration of capital and 3) the economic and social value.

*A surplus distribution approach*

A common way of distinguishing a for-profit from a nonprofit organization is by emphasizing that in the former the main aim is to generate a surplus to be distributed to the owners or investors as a reward for their risk-taking, whereas in the latter major objectives are other than to achieve a profit for distribution (Chambers, 1993:146,177). The issue is further elaborated in the associative literature dealing with member-user, rather than investor, based organizations. Excess of revenue over production costs *per se* is considered essential to economic efficiency. What makes the difference is the use of such an excess. Unlike the maximization of income based on invested capital, the underlying criterion for distribution of surplus in a membership organization is the extent of active participation of the member in its activities, or, as broadly called, "patronage". It follows that the existence of a surplus is an insufficient criterion of a for-profit organization. What matters is rather the rationale behind the distribution. Not less important for our matter is the extent of 'distributability' of the surplus, the point being that the latter may be aimed at, yet subject to the nondistribution constraint, a characteristic

of nonprofit organizations, as earlier mentioned. Being an economic enterprise is then a necessary, though insufficient, condition for the presence of a for-profit situation, the latter being justified by the maximization of return on invested capital.

Four dimensions have been suggested (Levi, 1998) for analysing organizations along an imaginary continuum from 'low' to 'high' profit orientation: 1) whether or not the organization is an enterprise; 2) whether or not a surplus is aimed at; 3) the extent of 'distributability of the surplus; 4) the way the surplus is disposed of. The emergent organizational types range from the 'non-enterprise' to the capitalist firm, through the 'quasi-enterprise', the multi-stakeholder cooperative of the Italian 'social cooperative' type, the commune-kibbutz organization, the traditional single-stakeholder cooperative, the multi-stakeholder cooperative of the Mondragón type, and the 'hybrid' cooperative .

It is argued that distribution of surplus cannot serve as a line of demarcation between for-profits and nonprofits. In other words, distribution of surplus cannot be seen as an exclusive feature of for-profits, as it can be found in cooperatives which are nonprofits. The cooperative shows how an organization can be an economic initiative, strive for a surplus, attain it and distribute it to its members/stakeholders in proportion to their 'patronage' and still remain a nonprofit. The difficulty of parting from the dichotomous profit/nonprofit way of thinking is at the root of the difficulty of

accepting the cooperative 'anomaly' in a world of neoclassical economics.

*A capital remuneration approach*

The secondary role of capital in the cooperative has a two-fold aspect: on the one hand it reflects the shortage of capital, a chronic weakness of cooperatives, and on the other hand it reflects a major edge of cooperatives over other organizations. Galloni (1996) sees the non-obligation to remunerate capital as a strategic resource for the cooperative. Whereas the capitalist firm shows a great extent of "downwards rigidity" with regard to capital remuneration so as not to jeopardize a minimum of profitability, the cooperative is free of such a constraint. Its 'profit' can remain limited to a mere balanced budget or a little above that. More specifically, the following degrees of 'profit' can be envisaged:

- ◆ a negative "profit", or loss, leading to a situation of inability , for any type of enterprise, to continue;
- ◆ a balanced budget, or a surplus below the prevailing interest rates, yet above inflation;
- ◆ a balanced budget with a surplus above inflation and approximating the income from common debentures;
- ◆ a high profit, in percent of invested capital, above inflation and return from common debentures (Galloni, 1996, pp. 57-59).

All the above, except the first, are net earnings after taxes, payment of all costs and provision for minimal reinvestment. The second one represents the possibility of a trade-off between capital remuneration and employment. The capitalist firm's "downwards inflexibility" often means a pressure on labour, either through wage cuts or/and downsizing. The cooperative 'downwards flexibility', on the contrary, can enable trade-offs between no capital remuneration and more employment and job security. So, exemption from capital remuneration, an obvious shortcoming by standard economics, can turn into a clear advantage from a perspective of creating employment and countering social exclusion.

In a similar vein, the point has been made that 'a nonprofit management whose employment is at stake, who has no ownership interest in the firm's assets, and who may feel a professional commitment to supplying the type of services produced by the firm, has a strong incentive to avoid liquidating the firm in whole or in part, and to keep it going at the largest scale possible regardless of the rate of return on its invested capital' (Hansmann, 1996, p.241).

*A social value approach.*

Producing social values can mean more than the conventional rendering of a service for payment, such as in the case of improving the quality of life, opportunities for encounters and interpersonal dialogue and exchange. Commercial firms too have a commitment to the production of social values such as reducing their negative externalities and contributing to employment. These objectives, however, are secondary to the fundamental objective of producing a profit or an economic value, in the absence of which the conditions for the normal functioning of the firm, in turn necessary for the achievements of the above social aims, may be impaired. On the other hand, the production of a social value constitutes a primary (not exceptional) objective for a nonprofit organization. The apparent contradiction between being an enterprise and a nonprofit at the same time is resolved by Milanese (1998, p.71) by distinguishing between maximal and minimal situations in attaining an objective. In cases where the value production becomes an operational objective to maximize, we have a situation characteristic of the for-profit firm where all efforts aim to go beyond the line of budgetary balance. If, conversely, producing the value only constitutes a 'condition/constraint' for autonomous existence, we have a situation where, regardless of whether the organization is a public body, a voluntary association, a cooperative or a religious group, the enterprise is a nonprofit one because the income level does not

represent a line to surpass by all means, but rather a simple limit to respect.

*In conclusion.* The notion of 'profit' is strongly related to that of 'surplus' and both are not absolute terms but rather continua. The cooperatives show the complexity of the issue. They are not bound by the 'nondistribution constraint' so they can decide to distribute, or abstain from doing so, part of their net earnings. Whatever the decision, though, their nature remains essentially a not-for-profit one, for capital is not the main production factor to be remunerated. As a sort of *enfants terribles* of organizations, cooperatives can be seen as symptoms of a wider phenomenon, namely the hegemony of the economic neo-classical paradigm which makes it so difficult to conceive an organizational model that blends the economic enterprise and the social concern, possibly subordinating the first to the latter. Excess of income over operational expenses in a traditional cooperative differs - in both its origin and final use - from the conventional meaning of profit. The existence of a surplus is insufficient to justify the element of profit, but is necessary to strengthen the cooperative economic base beyond the mere domain of services delivery.

A policy of encouragement of employment depends on strategies that bridles the domination of capital. Subordinating the latter to social considerations is the condition for the efficient pursuit of a policy of employment which puts human activity at the center stage. We can suggest that the essence of 'profit' does not lie in its alleged

essentiality to economic activity but rather in the way it is conceived and realized. When it is sustained by 'hard' categories of thought and the ensuing motivation towards accumulation of power and when remuneration of capital is used as the criterion for surplus distribution, we have 'profit' in its classical capitalist meaning. When the organization sees in the forfeiture of a surplus or its non-distribution or its distribution according to the member/stakeholder needs and patronage, an ethical value, we have the possibility of a *reconstruction* of 'profit' in its classical connotation.

### **What can we learn from the social economy**

Studies of the social economy, especially its component social cooperatives, highlight a number of characteristics that hint at the possibility to challenge the for-profit neo-classical economic logic by means of a nonprofit economic reasoning.

First, the alleged incompatibility between the notions of nonprofit and economic entrepreneurship has been invalidated on the ground of the entrepreneurial activity of typically nonprofit organizations like the social cooperatives of Italy and the social enterprises of the social economy, in general. Similarly, the belief that the optimal way to provide social services are through public bodies has been heavily undermined by the growing scope of services supplied by social cooperatives and similar nonprofits. The assumption that the major beneficiary of economic entrepreneurship is the entrepreneur himself has been weakened by the law and

practice of the social cooperatives that explicitly benefit the larger community, beyond the interests of the members (Borzaga, 2001; Colozzi e Bassi, 2003)

Profit maximization as a prime aim of an organization is excluded from the rules of cooperatives and other social economy organizations. While the attainment of a surplus – as the difference between income and expenses<sup>1</sup> – is a legitimate aim of any economic initiative (for-profit and nonprofit alike) its distribution, or nondistribution, cannot be considered as valid criteria for the presence of profitness, or the absence of economic entrepreneurship, respectively. As already mentioned, cooperatives, as nonprofits, often distribute surpluses to their members or other stakeholders, still remaining nonprofits. Similarly, many nonprofits can no longer be equated with non economic entities, as social cooperatives and social enterprises are economic initiatives that either abstain from distribution of surpluses, or are prohibited from doing so by law.

The above issues, when added to the well-known principles that subordinate capital to social considerations in the process of decision-making and surplus distribution, suggest an economic system that can co-exist with the notion of nonprofit. This could help the cooperatives to cope with the old issue of 'difference' by confronting the 'for-profit' paradigm with the 'nonprofit' one, this

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<sup>1</sup> 'While we are strongly of the view that organizations should strive for financial independence whenever possible, we would rather term any excess income generated as a 'surplus' than a 'profit' (Arthur *et al.*,2003).

time at the level of the social economy; on condition that such a 'nonprofit economy' can resist the alluring effect of assimilation to mainstream economics. The foregoing could well meet the requirement for a system offering an alternative 'of doing economy', namely a social economy that differs from mainstream economics as a social reality; as a scientific discipline; and as a methodological approach (Chaves, 1999).

A number of questions still remain open in the discussion of the social economy. If the broad reformatory ends of the social economy are credible, how can one distinguish - among the many organizations making up the third sector and the nonprofits- between those that do and those that do not, aim to such ends, or in other words, between organizations that challenge the dominant economic system and those that accept it as a *fait accompli*? How can the orientation towards servicing larger segments of society beyond the restricted realm of members match the requirements of the democratic practice? And, finally, how can the enterprises of the social economy cope with global competition while retaining their identity and how can this be done while insisting on using a negative language (*nonprofit, non-distribution*) borrowed from neo-classical economics?

### **A concluding note**

At the beginning of this paper we argued that cooperatives, especially in the light of their leading role in the social economy, can

substantiate the thesis that nonprofit and economy can go hand in hand.

To validate this proposition, let us review the main elements that characterize the nonprofit nature of cooperatives: 1) as economically change oriented, cooperatives and the other organizations making up the social economy, aim to achieve an annual operational surplus; this belies the image that 'nonprofit' means 'no-benefit', or 'working for nothing'; 2) cooperatives and related organizations are members', and not investors', based; 3) as such, the role of capital herein is at variance with that in a capitalist firm, playing no role neither in decision making nor in the distribution - if any - of surpluses; 4) unlike in a capitalist firm, capital in a cooperative - and even more so in a social enterprise - is not an end in itself but rather a means to achieve social, community and environmental ends; 5) a members' organization can distribute surpluses and still be nonprofit (see the cooperatives); 6) a members' organization can abstain from distributing surpluses and still be an economic enterprise (see the social enterprises and the social cooperatives). This implies doing away with the assumption that the mere 'nondistribution constraint' is sufficient, by capitalist standards, to indicate a state of absence of economic entrepreneurship.

The above suggest that a social enterprise, as most organizations of the social economy are termed, can be entrepreneurial and nonprofit at the same time and, possibly, part of the market without necessarily surrendering to the hegemony of capital. Assuming that a

social enterprise, in its broad connotation, abides by tenets of reciprocity, interdependence and long-termism in terms of benefits and rewards, we can appreciate how close we are to the concept of a 'nonprofit economy'.

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