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Editorial

Financing the third sector: Introduction

Abstract

Civil society organizations (nonprofits, social enterprises, voluntary, community and charitable organizations) are not only an integral part of the delivery of health, education, social, and other services in most developed countries, but also critical contributors to a healthy democracy and a strong economy. How civil society organizations are financed is a key aspect of their sustainability. Such financing is undergoing significant innovation and transformation. This financing ranges from traditional government funding and philanthropic support to new forms of revenue-generating social enterprises. In this themed issue of *Policy & Society* we bring together international scholars to critically examine the current changes underway in financing the third sector. The volume identifies and analyzes particularly innovative and effective strategies for financing this sector and assesses the implications for public policy through an intentionally broad range of cases that draw on the experience of a number of different countries in financing the third sector.

1. Introduction

The third sector (comprising nonprofits, charities, social enterprises, social movements, and other community-based organizations) is not only an integral part of the delivery of health, education, social, recreational and other services in most developed countries, but is also a critical contributor to a healthy democracy and a strong economy (Casey, 2004; Frumkin, 2002; Phillips, 2003; Putnam, 2000). In global terms, if these third sector organizations were aggregated as a country, they would collectively rank as the world's seventh largest economy, tied in GDP with France (Salamon, Wojciech Sokolowski, & List, 2003: p. 14). Ensuring the productivity, effectiveness and sustainability of this sector is thus an important public policy issue. How third sector organizations are financed is a key aspect of their sustainability, and such financing is undergoing significant innovation and transformation. Such financing ranges from traditional government funding and philanthropic support to new forms of revenue-generating social enterprise.

The impact of government retrenchment and fiscal restraint that took place in the 1990s had enormous effects on the third sector that is still being felt through greater competition, short term funding horizons, and more stringent accountability requirements. Internationally, an array of new changes in financing the third sector are underway that are arguably as profound as those of the past decade. These new developments are occurring not only in public sector funding but in the instruments, institutions and approaches being used by the private and philanthropic sectors, *and* in the creative intersections among these funding sources. Many of these new financing instruments bring considerable promise to enhance the productivity, innovative capacity and viability of third sector organizations (Young, 2007).

In this themed issue of *Policy & Society* we bring together international scholars to critically examine the current changes underway in financing the third sector. The volume identifies and analyzes particularly innovative and effective strategies for financing this sector and assesses the implications for public policy through an intentionally broad range of cases that draw on the experience of a number of different countries.

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2. International trends in financing the third sector

Comparative research on approaches to financing the third sector has expanded considerably over the past decade but still leaves many gaps and questions unanswered. The Johns Hopkins Comparative Nonprofit Sector Project (CNP), which has provided analysis of the composition of the nonprofit sector and financing patterns in 42 countries, has laid down a good baseline. It reports that, on average, 53% of revenues for the nonprofit sector come from fees, 35% from governments, and 12% from private philanthropy (Salamon et al., 2003: p. 28). The comparative analysis reveals considerable differences between developed and developing countries and among countries with different models of how the welfare state evolved in relation to civil society. Different kinds of third sector organizations will have different patterns of revenues: for example, faith-based organizations tend to rely much more heavily on donations than do health or social service organizations. Although there are limitations with such broadly comparative work, two general points stand out: philanthropy is the smallest component of financing in most countries, and earned income is the main source of growth in revenues.

However, as both civil society and its financing evolve quite rapidly, these traditional categories have become problematic. The notion that nonprofits earn income merely as an input to support their public benefit mission overlooks the growing presence of social enterprise in which the commercial activity is structured so it embodies a public benefit. New corporate forms do not force a choice between non- and for-profit but create new kinds of hybrids. In many counties these hybrid structures have led to new corporate forms such as Britain's Community Interest Companies (CICs), or the US L3C (LowProfit Limited Liability Company). Such structures enable legal entities to have greater access capital (a critical issue for social enterprise) that may have been restricted for nonprofits and cooperatives in the past. These new organizational forms support the hybrid nature of these enterprises by incorporating characteristics of for-profit companies which offer greater operating certainty and flexibility and those of the not-for-profit sector by ensuring profits and assets benefit communities rather than private gains.

How and for what purpose governments finance third sector organizations also varies considerably: much of government support actually flows as the purchase of goods and services and, in this sense is earned income for nonprofits. In short, the old distinctions in financing between means and ends and between non- and for-profit motives are becoming increasingly blurred and complicated.

In spite of considerable innovation in many countries, it is also evident that most have yet to establish a long term, sustainable approach to financing the third sector, as the recent financial crisis has so dramatically demonstrated. Donations and fundraising income have declined significantly, investments and endowments were hit hard, credit was restricted, grant income declined, all while demand for services increased (Charity Commission, 2009; Salamon et al., 2009). A survey of American nonprofits found that only 16 percent expected to cover their operating costs in 2009 in the face of a 90% rise in demand, and that over 50% thought the recession would have a long term impact on their organizations (Nonprofit Finance Fund, 2009). Indeed, many third sector leaders and some governments are arguing that out of this current recession, and the spending cuts that follow, may come an opportunity for radical solutions to how we deliver public services (Bubb, 2009), and will mean rethinking how we finance civil society organizations that deliver such a large proportion of public services. To date, governmental responses to addressing the impact of the recession on the third sector have varied dramatically from complete neglect to short term assistance, to creative use of social finance as an investment in the sector (as seen in the establish of a social innovation fund in the United States or the plans for the 'Big Society Bank' in England). In spite of some innovative approaches to financing in the third sector these organizations continue to face limited access to capital.

At minimum, what we should have learned from the financial crisis of 2008–2010 is that public policy matters for the viability and sustainability of the third sector, and that most governments have not been particularly creative in helping to build an appropriate policy architecture and adequate diversity of financing tools for this sector that would enable not only better public funding, but more effective private financing and a more enabling environment for social enterprise.

3. Approaches to public financing

The simple categorization of funding as either public sector, philanthropic, or earned income masks important differences within each of these three sources. In this volume, Rachel Laforest, Susan Phillips and Andrew Graham unpack approaches to public financing by analyzing the impacts of three distinct models. The charity financing model relies primarily on tax incentives to private donors, and thereby transfers decisions over which organizations to fund to individual donors and corporations. The more direct welfare state funding model is focused on allowing governments to procure services from nonprofits, although it may have a secondary interest in innovation and investment. The citizenship model uses public funding to support social change and active citizenship. In recent years, all of these models have been under pressure to some degree, resulting in a wide range of reforms and experimentation with new approaches to public financing. In many countries, including Canada which is the focus of their analysis, governments have not developed an adequate range of funding instruments so that, even when they seek to promote investment and social innovation, they are constrained into a procurement of services mode due to an over-reliance on contracts and contract-like instruments.

Calum Carmichael takes up the question of how effectively governments use the tax system to provide incentives for private giving. Depending on the criteria they set for what kinds of causes and activities can be subsidized to what levels, governments can channel philanthropy and shape its impact in different ways. Traditionally, governments have applied their subsidies (as tax deductions, credits or as top-up grants) uniformly: they set the criteria for which kinds of organizations are eligible to provide tax receipts. They may impose a ceiling on annual giving but within these broad parameters, they tend to treat all contributions the same and do not attempt to shape the decisions of donors. In recent years, several governments have been more directive in influencing where private contributions go by introducing differential subsidies, whereby the subsidy rate varies according to either the goods and services financed by the contributions (for example, providing higher tax credits to donations directed to services for low-income people), or by the nature of the contributions themselves (the type, timing, or increase over past giving). The analysis of eight countries that are using differential tax subsidies suggests that governments could be much more creative and achieve greater social impact through the use of this policy tool.

4. Enter social enterprise

With such dramatic changes across the third sector, new sources of financing to support civil society organizations are coming to the fore. Rather than abandon mission and purpose when faced with declining financial support particularly from government, organizations are coming to the realization that their activities generate a range of outputs and outcomes (social, environmental and financial) that add considerable value to their community. This set of ideas is sometimes referred to as "blended value" (Emerson, 2003). Once seen from this perspective, third sector outputs can generate streams of revenue that provide greater diversification of funding and sustainability for the organizations in the long run.

Diversifying financing streams beyond traditional grants, contributions and donations that have provided financing in the past, takes multiple forms across the third sector. These strategies can involve fee-for-service delivery both with the public and private sector. In Britain, for example, much of the push to new revenue diversification came in the 1980s under Margaret Thatcher's Conservative Government as service delivery was downloaded to the nonprofit sector and delivered by the sector for a fee. Sponsorship is another growing stream of financing for the sector, with corporations increasingly looking for ways to brand their products with worthy causes. A third avenue for the sector has been the establishment of business-like entities that generate revenue streams providing additional and dependable financial flows for civil society organizations. These ventures are often termed social enterprises.

Social enterprises run the gamut of aims, purpose and structure. For some the sponsoring body by definition must be a nonprofit organization with a democratically accountable governance structure and a distribution of surplus back to the organization. This definition holds true for most European countries and for the Province of Quebec in Canada and is reflected in the articles by Jacques Defourny and Marthe Nyssens and Marguerite Mendell featured in this special edition. Other definitions are more inclusive, though all see social enterprise as mission-driven entities. The UK Department of Trade and Industry (2003), for example, defines social enterprise as "a business with primarily social objectives whose surpluses are principally reinvested for that purpose in the business or in the community, rather than being driven by the need to maximise profit for shareholders and owners."

Social enterprises themselves can range from stand alone for-profit structures, often termed social ventures such as Ben and Jerry's Ice Cream, to entities that while structured as standards businesses, return their profits to their sponsoring organizations. Examples of this approach would be Goodwill and Salvation Army Thrift Shops. At the other end of the spectrum, social enterprises can be deeply embedded in the nonprofit and carry out the mission of the organization, as we find in programs that provide skills and training for hard to employ populations (see Alter, 2007, for a detailed typology of social enterprises). The fluidity of the term combined with the hybrid nature of the enterprises make it hard to pin down these organizations into a single neat definition. As a result, a myriad of terms are used to describe these endeavours including social ventures, social purpose enterprises, and social entrepreneurship. This lack of a single definition creates some confusion for policy-makers who wish to encourage social enterprises as a viable mechanism in the financing of the third sector.

One of the most pressing problems social enterprises face is access to capital for sustainable growth and development. Because so many of these enterprises are lodged in nonprofit and cooperative organizations, their very structure has often prevented them for accessing equity capital, while the lack of hard assets often restricts available debt capital. The result of this hybridity has been the development of a variety of new corporate structures in several countries around the world, Community Interest Companies in Britain, Social Co-operatives in Italy and L3Cs in the US are three examples. These structures have been designed to assist these hybrid enterprises to access capital more effectively in order to encourage their growth.

Despite its hybrid nature, the additional streams of revenue generated by these enterprises are becoming increasingly important for the overall financial sustainability of the third sector. Steven Rathgeb Smith examines the impact of hybridization on this sector. He argues that the emergence of hybrid organizations is not due to social enterprise alone, but represents the impact of diversification of policy tools in the last 25 years and the restructuring of the state under the influence of the "reinventing government" and New Public Management movements. Hybrid organizational forms thus need to be conceptualized as a strategic management tool as well as a policy tool of government-supported programs. His study suggests that, contrary to the expectations of many scholars and policymakers who fear that increased complexity reduces accountability and risks making more complex organizations ungovernable, hybrid forms can actually improve the governance and performance of nonprofit and public organizations. Rathgeb Smith goes on to say that, "Indeed, hybridization will increasingly be an asset in the competition for public and private resources in a turbulent and uncertain funding environment, especially in the context of the ongoing financial crisis in the US and abroad."

The theme of hybridization and its impact on the sector is carried further by Defourny and Nyssens as they explore these new financing mechanisms in Europe. Their article details the important role that public policy has played in the development of social enterprise and highlights that European social enterprises are positioned "at the crossroads of market, public policies and civil society" (Nyssens, 2006). For Defourny and Nyssens, the "hybridization" of European social enterprises combines "income from sales or fees from users with public subsidies linked to their social mission and private donations and/or volunteering. This clearly contrasts with a strong US tendency to define social enterprises as nonprofit organizations more oriented towards the market and developing 'earned income strategies' as a response to decreasing public subsidies and to the limits of private grants from foundations (Kerlin, 2009)."

It has been suggested that such enterprises "may be viewed as a pragmatic response to accessing diverse resources as a response to social enterprise development, or a purposeful approach to stimulating social innovation by bringing together a range of actors including staff, volunteers, and particpants of the enterprise, other not-for-profits, local governments and coporate sector organizations (Barraket, 2008: p. 131). Barraket goes on to note that while these hybrid organizations must manage the tension created by their orientation to both markets and states such tension can lead to productive discursive space within the organization. As suggested by Rathgeb Smith, hybridization is increasingly taking many different forms and can be seen as a strength, both for the nonprofit sector and for the policy regimes designed to strengthen the use of social enterprise to address pressing social issues and increase financial sustainability.

The United Kingdom's Office of the Third Sector, formalized in 2006, embraces the hybrid nature of the sector while utilizing a range of policy tools to strengthen its ability to deliver on a myriad of missions and approaches. New policy tools in Britain include a Risk Capital Investment Fund and the Big Society Bank currently in development that draws on unclaimed bank assets as a source of capital for social enterprises. We also find innovative public policy that embraces the hybrid legal forms of social enterprise (such as the creation of Community Interest Companies CICs) in order to address the problems that arise when non-share issuing entities seek to raise equity capital.[1] By embracing

[1] It should be noted however that despite these new legal forms not all enterprises are willing or able to take on these novel structures. Fully 74% of UK CICs are incorporated as companies limited by guarantee (March 2009). As a result these companies are not able to receive equity financing and therefore do not fully benefit from the public policy for which it is intended (BERR, 2009).

hybridization and developing a suite of policies to support the sector we find many social enterprises thriving in the UK context.

When we look to North America we see a vast difference in the role of public policy in strengthening and developing social enterprise. As noted by Defourney and Nyssens, the North American approach has been more reliant on earned income strategies developed on an ad hoc basis within the sector than on systemic public policy. Mendell explores the development of social enterprise in North America and finds that ‘‘social enterprise is placed on a continuum of initiatives that, for the most part, have been civil society driven socio-economic innovations to reduce poverty and revitalize communities in decline.’’ She explores social enterprise development in both the USA and Canada. With the exception of Quebec that tends toward Europe in its policy framework in support of social enterprise, Mendell finds North American social enterprise to reflect ‘‘marketizing social services, on profitability, to increase the capacity of nonprofits to address ‘social market failure’ through new trading activities.’’

Mendell suggests that in the absence of a strong public policy framework, foundations are playing an active role in shaping the development of social enterprise and social entrepreneurship in the US in particular. This theme is further developed by David Wood and Lisa Hagerman who explore the mission-based investment policies and programs used by foundations. Mission-based investing is the process of aligning a foundation’s core endowment investments with the stated aims and beliefs of the foundation. It is achieved through both market-rate investments that are often targeted at community endeavours such as affordable housing or employment opportunities in low and moderate income areas, and below-market rate investments that are part of the granting arm of the foundation and are known as Program Related Investments (PRIs) under US tax law. Social enterprises are able to access both loan and equity capital through foundations’ mission-based investments. Increasingly, US foundations are seeking ways to integrate their purpose and their investments to leverage available capital for community-based, nonprofit and purpose driven undertakings. While there continues to be a number of barriers to such investment, several US states have introduced a new legal form to facilitate equity investment in nonprofit social enterprises. The L3C or ‘low-profit limited liability company’ recognizes the need for hybrid legal structures that address the investment needs required to ensure the sustainability of social enterprises as they grow.

A number of philanthropists have taken up the mantra of social entrepreneurship as an effective mechanism to tackle society’s pressing issues. Many of these extremely wealthy individuals made their fortunes during the dot com boom of the 1990s. Bill Gates (Microsoft), Jeff Skolls (Ebay) and Pierre Omidyar (Ebay) are three that come to mind. Through their respective foundations these philanthropists are encouraging social enterprise and social entrepreneurship as a means to address social issues in ways that are both scalable and financially sustainable. They are building on their own success with scalable technology to seek similar approaches in the third sector. The Skoll Foundation, for example, describes its mission as driving ‘‘large-scale change by investing in, connecting, and celebrating social entrepreneurs and other innovators dedicated to solving the world’s most pressing problems. Social entrepreneurs are proven leaders whose approaches and solutions to social problems are helping to better the lives and circumstances of countless underserved or disadvantaged individuals (Skoll Foundation, 2010).’’

Lest we fall into the trap of believing that social enterprise is the new panacea for curing society’s woes, it must be noted that these entities can place strains on third sector organizations. Michael Edwards (2008) has provided a strong critique of these new approaches to financing the third sector. He describes this activity as ‘philanthrocapitalism’ and argues that many civil society organizations address issues outside the ‘market’ or seek to change the status quo and, as a result, are not compatible with conventional revenue-generating activity.

For many third sector organizations, such enterpreneurial approaches can provide significant challenges (Armstrong & Trillio, 2009). The current emphasis on business-based approaches and revenue generation can result in mission-drift and a loss of focus for nonprofit organizations. This is particularly true if the social enterprise comes to dominate the sponsoring body or if delivering on the original mission of the organization becomes too costly or time consuming when forced to compete with businesses unencumbered by social objectives. While efficient use of resources, measuring impacts and outcomes make sense for all organizations, running an organization in a business-like manner is not the same as running a business, as Edwards (2008) has noted. For many civil society organizations their goals fall outside the realm of conventional markets while their contribution remains critical for the well being of society.

The increasingly blurred lines between nonprofit and for-profit, through the rise of hybrid organizations and social enterprise and the adoption of more business-like practices by nonprofits, raises issues of whether executives should be paid in line with the non- or for-profit sector. Executive compensation has become a salient issue at various times over the years, often in reaction to a public scandal over excessive pay, but is now being challenged as a matter of public and organizational policy. Given the importance of maintaining public trust and ensuring that charities do not abuse their privileged tax status, they are legally subject to the ''non-distribution constraint,'' that excess earnings be directed to the mission rather than being distributed to 'owners' or members. But, as we encourage nonprofits to be entrepreneurial, should they be allowed and encouraged to reward their senior staff with performance pay? Elizabeth Keating and Peter Frumkin provide an analysis of the factors that determine how much nonprofit executives are paid in the United States and the extent to which pay-for-performance is common. They find that the pay of nonprofit CEOs is closely linked to organizational size and only modestly affected by CEO performance. Compensation is linked to ''free cash'' or liquidity, which may be inconsistent with the principle that profits are not distributed. While some may see the US as a distinctive case, particularly given the attention paid to private sector CEOs in the aftermath of the financial crisis, the question of the ability of nonprofits and social enterprises to compete is critical to the future of the third sector everywhere.

5. Looking forward

In light of the financial crisis of 2008/2009, the need to address the financing of the third sector is indeed a pressing issue. Issues of poverty, discrimination, affordable housing, healthcare, lack of opportunity and education must be addressed, and mission-driven third sector organizations are doing just that. But in most cases financing is ad hoc, undependable and declining in the face of growing need. Both government support and private philanthropy have declined, and it has become evident that many governments have outdated policy and regulatory frameworks and lack an effective range of public financing instruments. With revenue uncertainty and decline, new financing mechanisms are coming to the fore in the third sector. Most noticeable are social ventures and social enterprises that generate streams of revenue for sponsoring organizations. A defining characteristic of these structures is their hybrid nature. Such hybridity, unless it is embraced, as we find in jurisdictions like Britain, can be an impediment to the sustainable growth and development of these entities. Yet, the hybrid nature of social enterprise can also be a strength within the sector and a testament to the diverse nature of other-serving organizations. The challenges raised and opportunities created by this new complexity of financing the third sector, and the hybridity associated with it, are taken up by the authors of this volume of *Policy & Society.*

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