Revolutionizing the Nonprofit Sector through Social Entrepreneurship

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Abstract: While nonprofit organizations serve the community in significant ways, their heavy reliance on philanthropic and government funding is increasingly not sustainable, especially in the wake of economic downturns. The application of social entrepreneurial principles, including social enterprise activities, can improve the sustainability of the business model of nonprofits while bolstering management capacity and enhancing mission. This paper argues that the current funding model of the nonprofit sector should be disrupted in order to achieve a greater level of financial sustainability and mission-driven success.

Keywords: nonprofit; social entrepreneurship; hybrid; sustainability; innovation

JEL Codes: L30, M130, M140, D210

Introduction

While nonprofit organizations serve the community in significant ways, their heavy reliance on philanthropic and government funding is increasingly not sustainable, especially in the wake of economic downturns. With over 1.4 million active nonprofits in the United States competing for fewer and fewer dollars, organizations must seek new funding sources. The application of social entrepreneurial principles, including social enterprise activities, can improve the sustainability of the business model of nonprofits while bolstering management capacity and enhancing mission (Lyons, 2).

Increasing numbers of private foundations and funders are aggressively seeking to support social entrepreneurial ideas, yet many nonprofit organizations have been slow to think "outside of the box" to make their organizations sustainable. Confusion exists about the ability and legality of nonprofits to connect social enterprise activities to their overall missions, and there are well-founded fears that embracing new models may be financially risky, provide too many ethical dilemmas, or lead to "mission drift" (Foster, 2005). However, incorporating commercial strategies and activities, such as strategically selling goods and services, embracing a fee-for-service approach, or founding a separate commercial for-profit enterprise or hybrid business, may provide new types of revenue streams that will sustain successful nonprofits in the future. This paper argues that the current funding model of the nonprofit sector should be disrupted in order to achieve a greater level of financial sustainability and mission-driven success.

The Definition and Purpose of the Nonprofit Sector

The nonprofit sector provides goods and services that public sector governmental actors do not provide, and that private for-profit entities do not adequately, or are not able to, provide. Many nonprofits perform important functions, such as caring for homeless youth or working for social justice. The nonprofit sector is an umbrella term for organizations that serve the public good; there are 26 different categories of tax-exempt Internal Revenue Code 501(c) organizations — ranging from 501(c)(1) to 501(c)(27),[1] and

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[1] After June 30, 1992, prepaid legal services under 501(c)(20) were no longer tax exempt (Arnsberger 2010, 123).

a vast array of 501(c)(4) civic organizations, social organizations, and associations of employees that are tax-exempt, but donations to them are not tax-deductible.[2] Most familiar in American culture is the section 501(c)(3) category, in which organizations must serve at least one or more "religious, charitable, scientific, literary, or educational" purposes (Arnsberger 2008, 110). Charitable organizations may not be "organized or operated for the benefit of private interests" and no part of their "net earnings may inure to the benefit of any private shareholder or individual"[3] (www.irs.gov 2013).

The National Center for Charitable Statistics (NCCS) records more than 1.4 million tax-exempt organizations in the United States, comprising 945,415 public charities and 96,765 private foundations; 364,640 additional nonprofit organizations include chambers of commerce, fraternal organizations, and civic leagues. The charities category does not capture many of the 325,421 religious congregations and other religious organizations, typically schools, that are not required to apply for tax-exempt status, and it does not include nonprofit organizations that fail to bring in annual gross receipts of $25,000 or more (Arnsberger 2008, 111). The total number of nonprofit organizations in the United States is probably closer to 1.8 million.

The nonprofit sector is an important part of the U.S. economy. In 2010, nonprofits accounted for 9.2% of all wages and salaries in the United States and were responsible for 5.5% of the Gross Domestic Product (Nonprofit Almanac, 2012). The charitable sector,

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[2] Some unincorporated associations perform like charities, but are not 501(c)(3), including Alcoholics Anonymous. (Hall, 2005, 4) The National Center for Charitable Statistics reports there are 30,821 501(c)(4) organizations in the U.S. (NCCS 2013).

[3] Legally, a nonprofit corporation is "barred from distributing its net earnings, if any, to individuals who exercise control over it"—coined "nondistribution constraint" by Prof. Hansmann (Hansmann, 1980, 838).

which includes public charities and private foundation, "is a substantial and growing portion of the overall economy" with "aggregate book value of assets" of $2.5 trillion in Tax Year 2004; this marked a dramatic 222% increase reported for Tax Year 1985 (Arnsberger 2008, 110). That same year, public charities reported more than $1.2 trillion in revenue, with 70% coming from program services (Arnsberger 2008, 110).

The United States experienced an explosion in the number of nonprofit organizations between 1985 and 2004 (Arnsberger, 2008). The number of public charities tripled in the wake of a call for less government in the United States during the Reagan administration in the 1980s, and the so-called "Contract with America" in the 1990s that privatized traditionally public sector work, dismantled entitlement programs, and awarded contracts that were previously restricted to nonprofit organizations to for-profit businesses (Hall 2005, 23-24). The public sector increasingly viewed "business not as a pariah but as a role model" (Ryan 1999, 130).

The Rise of Social Entrepreneurship

This economic and political backdrop, coupled with the information and technology revolution, provided fertile ground for the birth of social entrepreneurship. The social entrepreneurship movement was founded when many factors, including global economic expansion and prosperity, increasing life spans and better health, higher literacy rates and access to higher education, global civil rights movements, and the disruptive advent of communication and information technology, came together in the second half of the 20th century (Bornstein 2010, 6-7).

Globalization and a broader knowledge of the challenges that face the world through 24-hour news services and the Internet have been game-changers. Bill Gates, in his 2007 commencement address at Harvard University at his 30th reunion, remarked that, when he was a student, he "just assumed that if millions of children were dying and they could be saved, the world would make it a priority to discover and deliver the medicines to save them. But it did not" (Gates 2007). Now, however, instantaneous communication lets us know, and social entrepreneurs can do something about the world's problems.

Social entrepreneurship is a modern global movement that is tackling the complex problems of our world – from poverty, hunger, and social injustice to the lack of access to health care, nutrition, and education.[4] Social entrepreneurs are driven and focused like lasers, disrupting unjust systems of inequality and suffering. They identify problems at a systemic level, and build innovative and sustainable solutions that bring about "a new, stable equilibrium" that provides "a better future for the targeted group and even society at large" (Martin 2007, 35).

Social entrepreneurs are leading a wide-range of businesses and organizations that pursue "mission-related impact"—a phrase coined by Greg Dees, who taught the first social entrepreneurship course in 1993 at Harvard University (Martin 2007). Social good or benefit, not shareholder profit, is the mission focus. Social entrepreneurs are transformative and "will not take no for an answer," and innovate solutions that can be measured and scaled (Bornstein 2010, 1-2).

Challenging the paradigms of "business as usual" for nonprofits, social entrepreneurs are pushing the perimeters of "their thinking about value creation, their business models, and their leadership styles" (Elkington & Hartigan 2008, 1). Social entrepreneurs have much in common with traditional entrepreneurs, and take risks, have

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[4] There is no agreed upon definition of social entrepreneurship; in this paper, I support a broad definition that "encompasses the activities and processes undertaken to discover, define, and exploit opportunities in order to enhance social wealth by creating new ventures or managing existing organizations in an innovative manner"(Zahra 2009, 519).

big visions, and embrace a "distinct business orientation" (Keohane 2013, 13). They blur the lines of nonprofit and for-profit work and they are laying the groundwork for how nonprofit organizations will be funded in the future. They are "forging partnerships with businesses, academic institutions, and government — building new markets and hybrid social-impact businesses, amassing a wealth of problem-solving expertise and changing the way governments work" (Bornstein 2010, 5).

It probably was only a matter of time before social entrepreneurs disrupted the nonprofit sector. Governments and markets are not solving the problems of our world, and too many of the 1.4 million active nonprofits in the U.S. are in survival mode, competing for fewer and fewer donor dollars, and do not have the capacity to scale (NCCS 2013).

Strategic Business Models for the Nonprofit Sector

I will discuss five viable models for nonprofit organizations to consider to generate additional revenue streams and achieve a more sustainable business model — ramping up the selling of branded merchandise, embracing a fee-for-service approach, founding a separate commercial for-profit enterprise, building a hybrid social enterprise, or transitioning from a nonprofit to a for-profit business.

The Human Rights Campaign (HRC) is the largest lesbian, gay, bisexual and transgender (LGBT) social justice nonprofit organization in the United States and is a good example of a nonprofit exploiting the selling of goods to augment its net income. It operates two retail outlets and maintains an online store; the operations sell branded merchandise that provided between 3-5%—from $1.26 million to $1.79 million—of HRC's net income during the last five years. Most important, this earned income provided a consistent revenue stream during the recession as donations plummeted (HRC Annual Report 2013). HRC successfully uses its merchandise to further its iconic equal sign brand.

Supporters purchase clothing, accessories, jewelry, and home and office supplies knowing that "100% of every purchase goes to HRC's fight for lesbian, gay, bisexual and transgender equality" (HRC Shop 2013). The earned income that HRC generates does not risk its tax-exempt status. Nonprofits can earn direct or indirect income, and even if the income is not "directly related to mission, there is always the option to pay the Unrelated Business Income Tax (UBIT)" (Lyons 2010, 3).

The non-profit Kaboom! uses a fee-for-service model to earn income to scale operations at a breathtaking pace, reaching $20 million in annual income within 10 years of its 1996 start-up (Hammond 2012, 201). For-profit corporations and businesses "hire" Kaboom! to design playgrounds, work with communities, order building materials, organize teams of volunteers, and, in a single day, actually build playgrounds in underserved neighborhoods (Hammond 2012, 199). Employees of Kaboom! meticulously keep track of their time spent working for various clients, similar to the practice of attorneys or consultants working in for-profit businesses (Hammond 2012, 201). These "billable hours" generate data on the true cost of the overhead of each project and the corporations sponsoring the individual playgrounds are billed accordingly. This fee-for-service model could be utilized by nonprofits wanting to keep an accurate accounting of the cost of time spent on specific grants. It also opens up a world of opportunities for nonprofits to seek out partnerships with for-profit businesses that work toward a social good. The legitimacy of nonprofits in American culture opens doors to donors and for-profit fee-for-service opportunities.

One of the lessons learned by Kaboom! during its meteoric growth was the need for "revenue diversification" despite the overwhelming success of the fee-for-service model. It secured funding through national partnerships and individual gifts, and received grants from foundations that were “focused on longer term impacts and capacity building” (Hammond 2012, 200-201).

Kaboom! Founder Darell Hammond argues that while fundraising is a critical role of the leaders of nonprofits, it should not be the primary focus. The mission of the organization should always come first. Hammond makes the case that “nonprofits would be far more effective if the people who ran them” were given appropriate funding “and a very short leash” comparable to for-profit companies’ receiving backing from venture capital firms (Hammond 2012, 203). Hammond dispels the myth that nonprofits are ignoring best practices in business enterprises; his non-profit business model is a great example of social entrepreneurship, although he is an outlier in the nonprofit sector. His business model can, and should, be replicated.

The third model that can be emulated is a nonprofit organization that starts a for-profit enterprise to fund a social good. The for-profit Alfond Inn and Conference Center opened in August 2013, and is owned and operated by Rollins College, a nonprofit liberal arts college in Winter Park, Florida. For twenty-five years or $50 million dollars — whichever comes later — all net proceeds from the Alfond Inn business enterprise go into an endowment for Alfond student scholarships. Once the primary objective is reached, the proceeds will flow to the college in perpetuity.

In 2008, the Rollins College Board of Trustees identified the building of a hotel as a strategic priority, and in April 2009, the College purchased the land for construction. Due to the economic recession, private investors would not fund the initiative, so the College needed to figure out a creative way to finance this expensive venture. The president and CFO of the college were able to make the case to the Harold Alfond Foundation for a $12.5 million grant; Rollins College paid $9.9 million outright for the land and funded a $20 million internal 25-year loan from the College's reserves at a 4.5% interest rate (Torre 2012). It was fortuitous that the late Harold Alfond was a successful entrepreneur (founding Dexter Shoes) and the foundation managers believed that he would have been thrilled with the decision to fund a non-traditional social entrepreneurial venture. In fact, the $12.5 million gifting agreement states that the Alfond Inn should maximize profits (Eisenbarth 2013). The College elected to register the Alfond Inn as a limited liability corporation (LLC) for-profit business rather than apply to the IRS for approval of a 501(c)(3) status in part because the request might have been denied, but also as a gesture of goodwill to the community. The Alfond Inn is expected to "generate approximately $260,000 per year in property taxes for the community" and Rollins does pay UBIT (Torre 2012).

Acknowledging that running a hotel and conference center is not one of its core competencies, the College hired a professional hotel management firm to manage the business and is confident that the firm will live up to the values and the ethical standards of the College; if not, another firm will be hired. This innovative mixing of a complex nonprofit spinning off a for-profit business in order to provide a sustainable revenue stream has been very successful at Rollins College, and the CFO has been receiving requests from other nonprofits to explain the model. Because of the uncertain funding future of colleges and universities, this is the first, but most likely not the last, for-profit venture that Rollins College will incubate. The Alfond Inn also serves as an example of a trend in which for-profit enterprises are awarded grants from foundations that traditionally supported only nonprofit work; additionally, venture funds and impact investors fund nonprofit social enterprises.

Blurring the lines of for-profit and nonprofit enterprise, hybrid businesses are the fourth category of sustainable business models that are changing the landscape of entrepreneurship. During the last five years, legislation creating low-profit limited liability companies, called L3Cs, has been passed in 9 states; benefit corporations, sometimes referred to as B Corporations, in 19 states and Washington, D.C.; flexible purpose corporations in California; and social purpose corporations in Washington state (Benefit Corp Information Center 2013).

Hybrid businesses are for-profit social enterprises that integrate social mission with making a profit. Rather than maximizing profits for external shareholders, these entities make social impact <u>and</u> improve human and environmental wellbeing. The laws regulating hybrid organizations vary by state, but as an example of a B Corporation in California, "the articles of incorporation of a benefit corporation may identify one or more specific public benefits that shall be the purpose or purposes of the benefit corporation" (CA Corporation Code §14610). Third-party auditors are required to annually assess "overall social and environmental performance of the benefit corporation" (CA Corporations Code §14630). And the Corporations Code requires that all decisions made by directors must consider the impact on shareholders, employees, customers, community and societal considerations, and the local and global environment (CA Corporations Code §14620). It is an example of the "triple bottom line" approach in business. Patagonia, the outdoor clothing retailer, was the first B Corporation registered in California in January 2012.

An interesting example of a new hybrid company is "Make a Stand," which sells fair-trade, organic lemonade as a social purpose corporation registered in Washington State. Five percent of all <u>gross</u> revenues funds six charities that work to end child slavery in the world. The lemonade is sold online to customers who decide if they would like to make an additional donation for the product, and retailers are also selling it in over 100 stores. "Make a Stand" is a for-profit social purpose company that has creatively integrated the sale of a product to fund a social mission (Make a Stand). The concept evolved when 8-year-old Vivienne Harr saw a picture of two child slaves working in a quarry in Nepal. Vivienne vowed to run a lemonade stand every day for a year to raise $100,000 to donate to an anti-child slavery nonprofit organization. It took her 173 days to reach her goal. After her initial success, she and her parents launched "Make a Stand," which, according to Ohio State Professor of Law and Finance Steven Davidoff, "may change the way nonprofits, and perhaps even companies are run" (Davidoff 2013, B4). There is large consumer demand for products that fund social change or provide a social benefit (Sakarya 2012, 1711).

The last category includes social entrepreneurs who turn existing nonprofit social-entrepreneurship organizations into for-profit enterprises.[5] Saul Garlick transitioned ThinkImpact Institute, his Colorado-based organization providing global social entrepreneurship immersion experiences in Africa and Latin America for college students, into a for-profit social enterprise because he was having trouble paying his employees fairly and on time, and he needed a capital infusion to scale the operation[6] (The Economist 2012). It remains to be seen if this business model will succeed in the medium- to long-term. The immersion experiences are out of the financial reach of most college students, and some nonprofit colleges and universities may balk at funding student experiences

[5] In 2003, Prof. Dees recognized the blurring of the "boundaries between the government, nonprofit, and businesses sectors," and the advent of a "new breed of social entrepreneurs creating for-profit organizations explicitly to serve social purposes" and personally profiting (Dees 2003, 1, 5).

[6] For-profit businesses have "a multitude of competing financial institutions" that provide access to a wide variety of financial resources; nonprofits do not (Austin 2006, 12).

provided by a for-profit entity.

Conclusion

The blurring of the for-profit and nonprofit sectors is just beginning, and will continue to slowly move "toward more integrated hybrid forms" (Battilana 2012). It is allowing social entrepreneurs to be creative in making a social impact, while at the same time making a decent living. Millennials and Generation Y folks born after 1980 are seeking jobs in this emerging sector; the number one factor young adults ages 21 to 31 want in a "successful career" is "a sense of meaning" (Smith 2013). Social enterprises can offer this sense of meaning along with success.

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