How Do Cooperatives Differ from Nonprofits and Why Does It Matter?
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This paper is an economic definition of the third sector building on the work of Gui (1991) that clarifies the distinction between nonprofits and mutual benefit organizations (*mutuals*), including cooperatives, that has often vexed prominent scholars. Three examples will suffice to make the point.

- Hansmann (1980, 1987) argued that being legally unable to distribute surpluses to individuals (the nondistribution constraint) sets nonprofits and clubs apart from market institutions. He explicitly excludes cooperatives arguing that they distribute surpluses to their members.

- In Amin, Cameron and Hudson's (2002, 1) view "the term social economy refers to not-for-profit activity geared toward meeting social needs" and, quoting Molloy et al (1999), specifies co-operatives; self-help projects; credit unions; housing associations; partnerships; community enterprises; and businesses. Unlike Hansmann, they identify co-operatives as not-for-profit.

- Anheier (2005, 52), observed that "Cooperatives, mutuals, and self-help groups share some, if not most, of the defining features of a nonprofit organization, and fall into a 'grey area' between the nonprofits and proprietary businesses. In some countries they are considered legally to be nonprofits; in others, not."

This paper develops a two-dimensional taxonomy that produces four mutually exclusive categories of non-familial institutions based on observable characteristics independent of malleable and unobservable motives and objectives. Is Google.org (an operating division of Google which espouses a social purpose) a philanthropist or a venture capitalist? Only its managers know for certain but everybody can accurately situate it within the correct category of the following taxonomy. This taxonomy shows how cooperatives and nonprofits differ for reasons unrelated to their motives and objectives but why the differences matter depends upon motives and objectives. The form of organization is a choice that is not immutable. The cooperative structure attracts organizations with certain motives and objectives while the nonprofit structure attracts a different group of organizations.

The first section of this paper classifies all non-familial social institutions. It is sufficiently broad to include government, business corporations, nonprofits, and cooperatives. It compares this taxonomy with the classification scheme developed by Quarter, Mook, and Armstrong (2009) in their recent work, *Understanding the Social Economy: A Canadian Perspective*. The second section explains what they have in common and why both are bona fide components of civil society and social economy. The third section addresses why their differences nevertheless matter.

Part 1: An Institutional Taxonomy

Every organization has a moral responsibility to act in the best interests of one or more persons. In certain cases – e.g., trusts and banks – the responsibility rises to the level of a legally enforceable obligation known as a *fiduciary* duty. But, in a broad sense every organization has a social role to act in someone's best interest, whether they are citizens, communicants, stockholders, or an indefinite constituency such as homeless persons or environmental advocates.

This paper will use the term fiduciary responsibility in the broad sense of moral obligation. Where a legal duty exists, there may be an additional moral obligation covering situations unimagined by law makers. Other terms used herein include *principals* who are the person or persons whose interests are being served and their *agent* who acts as their fiduciary.

If "interests" is substituted for "property" in Britannica's definition of fiduciary below, it would capture the essence of the term fiduciary as a synonym for agent.

> A *fiduciary* occupies a position of such power and confidence with regard to the property of another that the law requires him to act solely in the interest of the person whom he represents. [It] may be contrasted with persons in an ordinary business relationship, in which each party is free to seek purely personal benefits from his transactions with the other. (Britannica: http://www.britannica.com; legal definition)

In trust law and in mutual benefit organizations, principals choose their agents. By contrast, nonprofits choose their principals. The next section expands on and explores the implications of this substantial difference.

Figure 1 classifies organizations into four categories. Organizations are first divided according to the nature of principals. Each of these categories is divided according to whether the principals have any duties or obligations to their agents. It should be noted that this schema extends principal-agent theory instead of merely applying it; usually agents have responsibilities to principals but not the other way around (hence the names principal and agent). In other words, in the left-hand column of Figure 1 organizations are characterized by mutual obligations; in the right-hand column, the responsibilities run in one direction.

Along the top row of the figure on the next page are organizations having principals who are identifiable as specific individuals, generically referred to as *members*. If, upon dissolution, specific individuals are entitled to receive a distribution of an organization's net assets, those persons are its principals and the organization belongs in the top row.[1]

Figure 1[2]

Classification of Organizations

	Principals have responsibilities to agents: Yes	No
Principals are specific individuals	Partnerships, Clubs & Cooperatives	Joint Stock Corporations
Principal is a group	Governments & Other Public Bodies	Formal Nonprofits

Members of organizations in the upper-left shaded area (1) have responsibilities to their organizations and (2) they cannot transfer the rights and entitlements associated with principalship to someone other than, possibly, an incumbent member. Members may be able to withdraw and take something of economic value with them they did not have when they joined, but they cannot sell it and remain a member. In the unshaded area at upper-right, individual principals have no responsibilities to the organization and may transfer their principalship through gift or sale to anyone they choose.

Along the bottom are organizations having principals who are an indefinite constituency (a group) defined by their common characteristics (homeless, youth, etc.), not by individual identities. If no natural person is entitled to receive a distribution of the net assets upon dissolution of the organization, it has but one principal (a group) and it is situated in the bottom row.[3] Individuals within a group are generically referred to as *constituents*.

Constituents of organizations in the lower-right shaded area *cannot* choose their agents and consequently have no responsibilities toward them; their agents choose them through mission statements. In the unshaded area at lower-left, constituents *may* choose their agents by choosing where to live. They have responsibilities to their agents, the chief among them being the duty to vote.[4] The fact that many people never leave their birthplace does not negate the fact that they have the power to choose another location (and therefore, another agent), whereas constituents of nonprofits *cannot* chose their agents.

Of course, people often choose which nonprofit to patronize. Knowledge seekers choose which university to attend and sick people choose which hospital to visit. But, these people are subsets of constituencies generically referred to as clients. (In these examples clients also have specific names: students and patients.) The distinction is critical because clients may have interests that diverge from the larger constituency to which they belong because they want to extract as much value from the nonprofit as possible, even if it means less value for others. To illustrate: patients complain about being discharged from hospitals before they feel ready to go home. Universities with small acceptance rates have the ability to expand but choose to remain exclusive. If they see their mission entirely in terms of their own students and not a larger constituency, they are functioning as a club.

By focusing on principal-agent relationships, Figure 1 departs from various definitional conventions: (1) motive, such as profit maximization (public corporations), (2) type of output, such as public goods (government), (3) method of selecting leaders, such as voting territorially (government) or voting by ownership (public corporations), (4) powers, such as the power to tax (government), or (5) proscriptions, such as Hansmann's definition of nonprofits as organizations that cannot distribute their surplus to private individuals (Hansmann 1980, 1987).

The latter distinction is important because this analysis (although not Gui's) justifies giving primacy to the principals in a nonprofit organization's mission statement. It is important that a nonprofit's mission statement identify its principals because nonprofits are the only type of institution capable of choosing its own principals. It must be crystal clear whom it intends to serve for the sake of transparency and to give guidance to its own managers. A nonprofit has the freedom to change constituencies at will but a change should be a deliberate choice following internal debate, not the unintended result of insidious mission creep. Amending a mission statement is a conscious effort requiring debate.

Hansmann's definition of nonprofit organizations is one-dimensional. It does not distinguish them from governments or other public bodies. Worse, it leaves them berift of a mission. It is important to distinguish between *mission* and *objective*: a mission is a reason for being which is identifiable without being measurable, whereas an objective is a measurable expression of a mission. Acting in the best interest of citizens is government's mission; providing police protection is an objective. Acting in the best interests of shareholders is an exchange-traded corporation's mission; maximizing profit is an objective.

The most problematic issue in the schema of Figure 1 is the inclusion of business partnerships in the same category as clubs and cooperatives. Some observers may consider them to be market institutions. This paper argues that, to the contrary: (1) There is nothing illegitimate with clubs or cooperatives striving to maximize the net economic benefit to their members, as do business partnerships. (2) Regardless of mission and objectives, organizations consisting of persons with mutual obligations to each other have much in common that justifies setting them apart. (3) It is plausible (but must be empirically tested) that such organizations behave differently from organizations where rights of ownership run in one direction only.

A. Nonprofits

Nonprofits have a greater degree of *autonomy* than proprietary businesses or government because constituent control is weak. For example, they have no investor-owners looking over their shoulder, pressing for higher returns.

> While the One finds an abundance of suggested objective functions in the literature, such as maximizing budget (Tullock, 1966; Niskansen, 1971), maximizing quality and quantity in proportions specified by the manager (Newhouse, 1970; Hansmann, 1981), maximizing the use of preferred inputs (doctors, high technology and prestigious medical procedures, or handicapped employees (Lee, 1971; Clarkson; Pauley and Redisch, 1973; Feigenbaum, 1987), maximizing a combination of commercial and charitable or public benefit outputs (James, 1983; Schiff and Weisbrod, 1991; Eckel and Steinberg, 1993), maximizing 'profits' (Preston, 1988), or social welfare (see Holtman, 1983). (Steinberg 1993, p. 17; the citations in the quotation are omitted from the reference list of this paper.)

Autonomy makes nonprofits ideal vehicles for infusing economic activity with ideological, spiritual and cultural values. As Rose-Ackerman says, nonprofit customers "are buying reified ideology" (1997, 128). These organizations practice *values-centered management* – a control regime in which social, cultural, and spiritual values, individually, or in combination, are incorporated into a business plan.[5] Maximizing net cash flow is the paramount guiding principle for proprietary businesses but it is no more than one – if that – of several guiding principles for values-centered managers. In areas of activity where social, cultural and spiritual values are associated with goods and services, religious groups have played a prominent role.

Some nonprofits are expressive rather than instrumental (Frumkin 2002), meaning that they advocate for a cause rather than provide goods and services. The constituencies of such organizations consist of all persons who share their principles. Churches are perhaps the best example of expressive organizations. "Universally, religious groups are the major founders of nonprofit service institutions. We see this in the origins of many private schools and voluntary hospitals, in the U.S. and in England, Catholic schools in France and Austria, missionary activities in developing counties, services provided by Muslim wacfs [religious trusts], and so on" (James 1987, 404).

To some observers, (Ott 2001) hospitals are "large and highly commercial" enterprises that "do not look, feel, or act very much like the mental images that most of us have of nonprofit organizations."He does not describe the image but implies that it has to do with owning little wealth and helping the poor. This paper suggests, however, that opera companies, research libraries, lapidary museums, and even large commercial nonprofits are legitimate members of the nonprofit community provided: they are managed in the best interest of their respective constituencies. There is a body of literature that lends credence to the supposition that nonprofit hospitals are managed differently from their for-profit counterparts (Schlesinger and Grey 2006).

B. Mutual Benefit Organizations

Buchanan (1965) developed a theory of clubs which has proved useful for analyzing a wide range of economic and social phenomena. It assumes mutual benefit organizations strive to maximize the *average* net benefit to their members. The assumption is that every member experiences a positive net benefit. If they did not, they would leave (or "exit" in Hirschman's phrase). Thus, no member subsidizes another, but members may derive differing net benefits.

Recall from the introduction that Hansmann (1980, 1987) includes ordinary clubs in his definition of nonprofit but explicitly excludes cooperatives arguing that clubs do not distribute their surpluses to their members whereas cooperatives do. But, this is a distinction without a difference. When a club dissolves, its members are entitled to divide any residual equity among them selves, which is clearly a distribution to private parties. If the persons who benefit from an organization also control it, the nondistribution constraint merely forces implicit rather than explicit distribution (Gui1991, 566). A club that disposes of a surplus by reducing dues or squandering it on a lavish party for its members is doing no more and no less than a cooperative that sends every member a dividend check.

Members of mutual associations are specific individuals who control them by direct vote. How the votes are weighted is immaterial in Figure 1 – they maybe equal or weighted according to ownership of assets or usage). Although they may have pro-social interests beyond the self-interest of a specific group, they exist primarily to serve their members and the way their members perceive the social role of the organization.

Where constituents control a board of directors (typical of arts and culture organizations) of a nonprofit organization, feedback is immediate and direct. On the spectrum of control described by Figure 1, these organizations are closer to mutual associations than to social services serving vulnerable populations which typically do not have constituent representatives on boards.

Unlike actual membership associations, direct election is impossible because of the indefinite nature of the constituency that constantly changes with people dropping in and dropping out. And, without direct election there is ample room for guesswork and anecdotal evidence in reaching strategic decisions. Dialogue between boards and management is still essential.

Part 2: Commonalities

The two shaded lobes of Figure 1 constitute civil society, although some might disagree. According to Fukuyama (1999, 5), "Civil society refers to the set of institutions that do not belong to the extended family, the market, or the state [which] serves to balance the power of the state and to protect individuals from the state's power." He does not comment on business partnerships, which fall in the upper left hand cell, but he might regard them as market institutions because of their objective of making a profit.

However, profit is a means to the end of serving shareholders. Being profit-oriented should not be sufficient grounds for reading cooperatives and nonprofit institutions out of civil society. If a profit orientation were off limits in civil society, social enterprise in general and British Community Investment Corporations would be similarly orphaned.

Besides, both lobes of civil society are necessary to accommodate all legal structures used by advocacy organizations and religious congregations – which are accepted as essential institutional components of civil society. Some advocacy organizations are mutuals under member control, whereas others have self-perpetuating boards. Religious congregations may be democratic or hierarchical. Democratic congregations (e.g., Friends or "Quaker") are mutuals because they make major decisions by vote of their membership. Hierarchical congregations (e.g., Roman Catholic), although they have members, have more in common with nonprofit organizations than mutuals, because their members do not elect their spiritual leaders. The leadership of hierarchical congregations is self-perpetuating, as is the leadership of nonprofits.

The taxonomy of Figure 1 helps resolve Anheier's and Hansmann's conundrum over whether clubs, cooperatives, and nonprofits belong to the same class of institutions. As a two-dimensional structure it has more degrees of freedom than Hansmann's nondistribution constraint alone. Figure 1 shows that clubs and cooperatives belong together but that they are distinctly different from nonprofits.

Nonprofits and cooperatives belong to the social economy as well. Delors and Gaudin (1979) and Gui (1991) describe it as non-state, non-capitalist organizations – a definition which sounds similar to Fukuyama's description of civil society. On the other hand, Quarter, Mook, and Armstrong (2009, 4) introduce motive into the picture:

> *Social economy* is a bridging concept for organizations that have social objectives central to their mission and their practice, and either have explicit objectives or generate some economic value through the services they provide and purchases they undertake.

Quarter et al place clubs, cooperatives, and nonprofits together in the category of civil society. They are not interested in deconstructing civil society, preferring to focus on how its parts interact with pure market institutions and governments. They view social economy as consisting of civil society plus public sector nonprofits (part state-part civil society), plus social economy businesses (part private sector business-part civil society), plus community economic development organizations (part state-part private sector business-part civil society). Although civil society is the common denominator, their version of social economy bleeds into the public and private sectors. An organization belongs to the social economy if it has a social mission and produces economic value.

Should the social economy include organizations funded and controlled by the state? Parts of francophone Europe exclude them (Ibid. 5) presumably on the grounds that their dependence on the state relegates them to being mere appendages. Conversely, should the social economy include independent organizations if their mission is exclusively limited to supporting a state institution? The latter case may seem far-fetched to Europeans who enjoy a tradition of free public universities but in the United States the premier public university in nearly every state has an independent private nonprofit foundation with a self-perpetuating board whose sole function is to raise private funds and to manage endowments for the exclusive benefit of the university to which it is committed. Quarter et al's expansive definition welcomes both types of state-nonprofit hybrids under the label public sector nonprofits.

This paper classifies all hybrids according to whether there are reciprocal obligations between the component organizations or whether responsibilities of ownership run in only one direction. Upon dissolution of a government-nonprofit partnership, if the government receives 40% of the net assets and the nonprofit receives 60%, then the hybrid is 40% public and 60% social economy.

Part 3: Why Does the Distinction Matter?

The discussion thus far has answered the first part of the title question, concluding that nonprofits have a single principal that is a group of people defined by their common characteristics, whereas cooperatives have multiple individually identifiable principals – their members. Further, nonprofit principals have no obligations to their agents, whereas the principals (members) of cooperatives do have reciprocal obligations. The distinction matters because of constituency, adaptability and accountability.

A. Constituency

In their study of 195 individual social economy projects in the UK, Amin et al (2002, ix) concluded that

> areas of marked social exclusion are precisely those that lack the composite skills and resources necessary to sustain a vibrant social economy, resulting in either highly precarious and short-lived ventures that fail to meet local needs, or ventures reliant on public sector leadership, peripatetic professionals and social entrepreneurs, dedicated organizations such as religious or minority ethnic bodies, or market links that stretch well beyond the modest offerings available locally.

Their insights relate to communities heavily populated by *les exclus* but we might extrapolate backward to the organizational level. Cooperatives and other mutual self-help organizations require skill sets that some individuals lack. These people are precisely the ones most at risk of being excluded from the mainstream market economy and organized political activity. However, they are also the natural constituency of charitable nonprofit organizations.

B. Adaptabilty

The New York Stock Exchange (NYSE), otherwise known as the Big Board, is an icon of global capitalism. Many people are surprised to learn that it functioned as a cooperative for the first 214 years of its existence. It existed to serve a select group of traders who controlled it and benefited economically from it.

The NYSE found it difficult to respond quickly to business threats and opportunities (Henriques 1999). Major decisions had to be submitted to the full membership for a vote. In nonprofits and proprietary corporations decision-making authority is delegated to a board of directors who can act for the organization without consultation. (In matters involving disposition of assets upon liquidation, nonprofits must their state attorney general.) The members ultimately voted to de-mutualize and convert to a for-profit organization. Had the board been able to act without consulting its membership, it might have elected to issue bonds to raise capital for expansion.

Although the NYSE became for-profit, its story calls attention to an advantage of nonprofits that cooperatives lack. Like for-profit corporations, nonprofits are able act quickly in response to threats and opportunities – that is, to adapt to a rapidly changing environment. Put another way, the cumbersome internal control mechanisms of cooperatives render them vulnerable to making errors of omission.

C. Accountability

The other side of the adaptability coin is accountability. Not having to answer to their principals render nonprofits vulnerable to making errors of commission. Using 85 qualitative interviews in three low-income Philadelphia neighborhoods, the Kissane and Gingrich (2004) showed that directors of nonprofit community development organizations held similar views on community needs but their views diverged from the views of residents within their own communities. Directors focused more on employment and training, while residents focused more on crime and safety.

Part IV: Conclusions

Although, nonprofits and cooperatives differ on at least two dimensions but both are essential to civil society and social economy. The differences between them render cooperatives vulnerable to making errors of omission. and nonprofits vulnerable to making errors of commission.

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Endnotes

[1] These definitions are not dependent on there being anything of value left to distribute upon dissolution. It depends only upon who is *entitled* to receive a share if one were made. The test will locate an organization in one or the other category. Further, some clubs, such as trade associations, have other organizations as members. This does not negate the classification schema.

[2] Figure 1 is roughly similar to a structure first proposed by Benedetto Gui (1991) who identified beneficiary and dominant groups. Beneficiaries possess legal rights to an organization's surplus and the dominant group consists of persons possessing the legal right to control the organization. Beneficiaries play the role of principals in this analysis and the dominant group plays the role of agents. The correspondence is not exact however because Gui does not distinguish between uniquely identifiable beneficiaries and an undifferentiated group of beneficiaries. Furthermore, in this analysis an organization has a fiduciary responsibility, regardless of who controls an organization or whether they have a legal right to do so.

[3] These definitions likewise are not dependent on there being anything of value left to distribute upon dissolution. It depends only upon who is *entitled* to receive a share if one were made. The test will locate an organization in one or the other category. Further, some nonprofits may exist to serve as a resource for other nonprofit organizations without having a permanent relationship with any one of them. This does not negate the classification schema.

[4] Stockholders have the power to vote but not they duty. They may appoint proxies to vote in their behalf.

[5] This should not be confused with "*value* based management" (singular) which seeks to maximize net cash flow. An early use of *values* based management (plural) was Peter Pruzan's 1998 article "From Control to Values-Based Management and Accountability" but he envisioned it as the negative of control: "From a focus on efficiency and control to a values-based perspective on management, corporate identity and success. And from a focus on legal compliance and financial performance to a focus on corporate social and ethical responsibility and accountability."