Member Area

Perspectives

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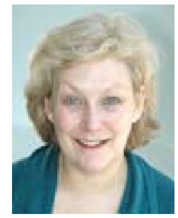
Let's Be Brave: Demand "Enterprise Friendly" Deregulation for Nonprofits



Clara Miller is president and CEO of the Nonprofit Finance Fund, a national leader in helping nonprofits strengthen their financial health and increase their capacity to serve their communities. This column is part of a series of Perspectives columns in which leaders from our community examine the system for financing nonprofits. This month, Clara examines, in concert with two colleagues, three particular problems that create trouble for the business operations of nonprofits.

Many have spoken eloquently about the value of the nonprofit community, about the tangible and intangible contributions it makes to the public good. One recurring theme is that the sector is inhabited in large portion by individuals who have an avocation. We are called to serve, to help, to create, to study, to teach, to heal, typically placing these commitments far above all other considerations. We are, in large part, incautious about the earthly consequences of being and doing primarily with others in mind. By way of sectoral aspiration, we needn't look farther than the Boy Scouts' motto: trustworthy, loyal, helpful, friendly, courteous, kind, obedient, cheerful, thrifty, brave, clean and reverent!

So what's wrong with that? Well, nothing, exactly, except that the unintended consequence of being unfailingly thrifty, cheerful and brave is that we are undermining our ability to be helpful, trustworthy and kind in the future. We are at a crossroads (we may even have missed a turn a few miles back) where our collective willingness to be good scouts -- to do "anything it takes" to fulfill our missions -- has become subject to the laws of diminishing returns. And because we're friendly, courteous and obedient, we have unwittingly accepted, even welcomed, overbearing, uneven and counterproductive rules, red tape, and regulation from government funders, donors, and agencies such as the IRS.

No one wanted the nonprofit community to have an operating climate that could make a grown manager cry. But because we rarely focus on the business aspects of what we do, we haven't been tallying the collective cost in effectiveness and efficiency of a hostile operating environment. If we were the National Association of Widget Manufacturers, for example, we would have long since cried foul: "you're over-regulating small business…how can we generate jobs and provide goods and services when you're tying us up in red tape?" A typical manager of a child services operation is more likely to be thinking, "I'm the only thing between this child and the streets, I've just got to make it work, even if I'm taking 50 cents on a dollar of cost, and they're asking me to help more kids," instead of the business person's straightforward: "you've got to be kidding, I can't make any money doing this! I'm getting out!" We hang in there, and let everyone load it on, with no weather eye on the destructive effect on quality of services and mission outcomes.

For this column, I reached out to two people. The first was Hilary Pennington, director of special initiatives for U.S. programs at the Bill & Melinda Gates Foundation, previously president and CEO of Jobs for the Future, a national intermediary that works with social service organizations to improve career outcomes for low-income youths and adults. The second was Nancy Wackstein, executive director of United Neighborhood Houses of New York, an umbrella for 34 settlement houses and community centers in metropolitan New York. We have slightly different points of view, but together we generated examples of how our sector's best impulses can become our worst enemies. And in a related vein, we noted ways that ignoring the business side can undermine the great outcomes we're all hoping for.

- **Overregulation and over-restriction**, with too many well-meaning cooks in the kitchen: While the vast majority of nonprofits are microscopic by for-profit business terms (less than $100K in annual revenues, and runs substantially on volunteers), let's take a $1 million community center, more similar to a small business in size and employees (roughly 8 to 14 full-timers). If it's like many of the ones we lend to and advise at Nonprofit Finance Fund, it gets about 60 percent of its revenue from 12 government contracts, for everything from senior meals on wheels and ESL instruction to vaccinations and midnight basketball. Each contract is from a different level and department of government, each is intermittent, and each has different (and sometimes conflicting) regulations. Complementing that revenue are likely five to ten foundation grants each with slightly different restrictions; some earned revenue from sources such the use of the gym and rentals to child care centers; and other income, like proceeds from the dinner dance and bingo receipts. In essence, each is a separate line of business, requiring varying skills and systems. Complex management? You bet.

  Wackstein notes that on top of this is a formidable one-two punch. First, our mounting list of best practice recommendations -- each completely reasonable on its own -- that add cost and complexity with no increase in revenue. Second, the emergence of performance-based contracts that have a profound impact on cash flow, and therefore require re-jiggering of capital structure through steps such as addition of cash reserves or credit lines in advance of receivables. The result? Accountability and performance, both laudable goals, become increasingly difficult to deliver because funding prohibits managers the flexibility needed to perform well. She observes, "as the drive toward accountability and performance measurement has intensified from all sides, the operating environment for nonprofits has never been more difficult."

- **Inappropriate Regulation**, from a "healthy enterprise" perspective, let's turn to organizations that deliver upwards of 95 percent of their services under contract to the government -- workforce development, let's say, or foster care. Nonprofits with these contracts deal with a host of rules that add cost, don't improve services, and actually make it more difficult to operate. Because of line-item restrictions on expenditures, Pennington explains: "Many can't put into place routine, minor business investments such as staff travel for training opportunities." And she cites an even more counter-productive practice: operating efficiencies are difficult to achieve because combining revenue streams targeted at discrete recipients or purposes is routinely prohibited, even when there would be overall savings. Both Wackstein and Pennington described government units' tendency to require separate and complex accountability and performance metrics for each program, without regard for cost, complexity, or size. Multiply that by a dozen government contracts, as in the example above, and the collective impact becomes apparent. At NFF, we've worked with some social service organizations that must spend down their cash reserves before receiving government reimbursement, thus increasing business risk sharply. Moreover, when some of our borrowers made energy efficiency improvements, their government contracts did not allow them to shift the savings from the energy line to fund another line item, a kind of "whole budget" approach that a regular commercial business would assume. Instead, reimbursement rates were cut, also destroying the incentive to cut costs.

  But government is not the only "buyer" of nonprofit services that demands nonprofits take on "enterprise unhealthy" management practices. Foundations and even individual donors follow their own sets of rules. Pennington noted a tendency we all had witnessed, "government funding at least allowed us to calculate and charge our indirect cost rate equivalent to an overhead rate…that came closer to the real cost than the foundations, who were more likely to assign an arbitrary rate.

- **Business Models that Drive the Wrong Social Outcome**. In some ways, we have created the worst of all worlds, one where we are squandering our most precious resource: people. It's common for government to buy goods and services on a cost-reimbursement basis, where delivery releases payment. This is fine when the government is buying, let's say, military vehicles from General Motors. If the truck is delivered, and if it meets the specs, GM gets paid. It gets more complicated when the service is foster care and the children's home is expected to deliver adults ready to lead fulfilling and productive lives, despite steep personal challenges as children. This outcome might take years. But if the business model drives payment to government contractors (who are increasingly for-profit businesses) on the basis of beds filled at a foster care residence, we're providing a powerful business incentive for the contractor to downplay what we really want: getting children graduated and into families, jobs, and lives. The business model for service delivery, therefore, drives the wrong outcome for everyone: the taxpayer, the child in foster care, and the people who are called to mission-based work with these children. Even the for-profit provider would probably simply say, "I hear you, but that's how the government set up the regs -- we get paid when there's a kid in the bed. What's my incentive to help get them out?" Far from using the powerful tools of private enterprise to reach social goals, we are doing the opposite

Pennington, Wackstein and I agreed that the key is working toward enterprise-friendly practices by all funders: finding the right mission-based, long-term incentives in the form of quality program outcomes, rather than budget inputs, such as overhead rate; applying the "whole enterprise" lens to investing and purchasing principles, beyond the typical isolated program budget, and deploying comparable metrics on finance, capacity and program output among peer organizations. In addition, our sector and its beneficiaries -- funders, nonprofit managers, board members and the public -- must become aware that nonprofit organizations have exactly the same business requirements as for profits, but a much more difficult business proposition.

People in commercial businesses know that you can't deliver on promises without the appropriate capital base (cash is king!), skills, systems and, most importantly, profits to provide cash to reinvest in any organization. It's especially difficult to manage in a growing, mission-based organization where overregulation routinely prohibits investment in IT, and financial systems, management training and HR -- all straightforward requirements of any business. We need to recognize these problems, fiercly guard the mission side of what we do, and begin working to improve things by being a little less obedient and a little more brave!

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