

Nonprofits in Recessions, Where the Buck Stops, and Is That Good for Columbus?

Presentation by Allen J. Proctor
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I welcome the opportunity to bring you “backstage” so you can see the nonprofit world as we know it today and understand the forces that have molded it. Most of us think of nonprofits as those organizations who are always asking for money. Nonprofit is a misleading term because nonprofits need to be profitable in order to survive, no differently than a for-profit organization. What they really are are 501(c)(3) charitable organizations. What makes them different from your business is that one-third of their workforce consists of volunteers who work for no pay and our donations to them are exempt from federal income tax. To qualify as a 501(c)(3) they must provide services in at least 1 of 9 broad categories specified in the Internal Revenue Code.

We here in Ohio are more aware of nonprofits because we rank 7th nationally in the number of nonprofit workers, exceeded only by NY, CA, PA, TX, IL, and FL. Yes, we beat Michigan! In fact, over half of all nonprofit workers in the nation can be found in just 3 of the country’s 9 census regions: middle atlantic, south atlantic, and east north central where Ohio is located. In Franklin County, one out of every 12 workers in 2002 was employed by a nonprofit. And that really understates its importance because significant similar institutions, such as Columbus State, OSU, and OSU medical center, are governmental and therefore not included in nonprofit statistics. At the same time significant local institutions such as Battelle, Chemical Abstracts, and OCLC are included.

Compared to the nation, healthcare is unusually predominant in Ohio nonprofit employment, accounting for three-fifths of all nonprofit workers in Ohio. The greatest overall concentration of nonprofit workers in Ohio is in health services, social services, and educational services.

The predominance of these three areas is symptomatic of a trend that started over 20 years ago to replace government employees with nonprofit volunteers and paid employees. We will see later that the motive for this trend has implications that are not necessarily good for our community.

So, let’s see how this occurred. In the 1980s, the Federal government, in order to save money, began imposing obligations on the states that were not matched by increased federal funds. The term “unfunded mandates” was coined to describe this phenomenon. While the states complained about the federal government, when state budgets became tight in the late 1980s and early 1990s, the states did the same to local governments: they

http://www.linkingmissiontomoney.org/insitutional_resources.html

created unfunded or underfunded mandates in healthcare, social services, and education, among other areas.

In addition, the 1990s brought another trend: outsourcing. In an effort to hold down state and local government employment, governments began to outsource or abandon specific services to the nonprofit sector.

For example, most art and cultural educational programs are now provided by local nonprofits. The 16 largest local cultural organizations, represented by the Columbus Cultural Leadership Consortium, provide educational outreach programs to 930,000 school children annually. And they serve 4,000 teachers each year through professional development and continuing education programs, and provide another 55,000 adults with continuing education programs. They do this because our public education system does not.

And I could drown you in statistics for how the nonprofit sector is now the primary provider of shelter for the homeless, food for the hungry, and clothing for the naked: food banks, homeless shelters, individual and family services, job training, child daycare, residential services; you can fill in the rest of the list.

If you looked at charity care data for our nonprofit hospitals, you would see once again that nonprofits have stepped in where our governmental healthcare programs, Medicare and Medicaid, have fallen short.

The most recent example of nonprofits filling a void that government once filled came in the February 11 Dispatch headline: “As city recreation centers prepare to close, nonprofit groups try to fill the void.” The key word here is “try.”

This trend, of nonprofits’ providing services that governments traditionally have provided, is reflected in two ways. First, by 2002, employment in the Ohio nonprofit sector was over 3 times higher than employment by Ohio governments. In the next two years, while total employment in Ohio declined by 0.2%, employment by Ohio nonprofits increased by 14.7%. This growth wasn’t due to nonprofits’ mindless ambition; much of this growth was prompted by the continual shift of formerly government-provided services to non-profit-provided services.

The second part of this trend is financial. And it is the story of the unintended consequences of the effective philanthropy movement and the effort by both government and philanthropy to leverage their funding to nonprofits.

In order to save money, state and local governments stopped paying nonprofits for the full cost of providing those services. As a business, would you accept a contract that paid you only \$4 for every \$5 of your costs? Yet these are generally the terms that state and local governments impose on nonprofits. The reality of this is that the full cost of providing these public services goes from being the shared obligation of all taxpayers to

being an extra obligation of the smaller set of taxpayers who choose to be donors to the nonprofits.

Unfortunately, in the past 10 years, the largest donors have embarked on a path, often referred to as “effective philanthropy,” that seeks to leverage the impact of their grants and that has had the same effect as the government’s policy, namely they have shifted more of the financial burden for services onto the nonprofits. For large donors effective philanthropy is represented by four increasingly common policies that are phrased along these lines:

- “We do not provide operating support, we only fund programs; or
- “We require matching funds before a grant will be awarded; or
- “We provide only start-up funding so that you, the nonprofit, must take over the full cost of the program in a few years; or, finally,
- “We require registration and customized reporting before you will be eligible to be awarded a grant or contract. No, you must bear the cost of our requirements.”

Each of these policies has weakened the financial health of our nonprofit sector, made it even more dependent upon attracting donations from an ever-narrowing pyramid of support, and made nonprofits especially vulnerable to the current economic climate.

Before going into possible responses, I want to spend a minute to address the myth of endowments. Many in this community attribute the vulnerability of our local nonprofits to the relative absence of endowments compared with institutions in Cleveland and other large cities.

Let me state this very clearly: Endowments are not a source of financial stability. In fact, they act as a magnifier of both good times and bad times. Case in point: which university on this list has announced lay-offs: OSU or Harvard? Answer: Harvard, which has the largest university endowment in the country. Why? Because Harvard bases one-third of its operating budget on the ups-and-downs of the investment markets while OSU bases only 3% on its investments. As businessmen, you know your resiliency is based on your retained earnings and working capital. Endowments are neither.

Let’s talk a bit more about balance sheets. You know that your business’ balance sheet is the foundation of your financial strength. And equity is a significant measure of that strength. Nonprofits generally have virtually no equity. In general, and in large part due to the trends I’ve just discussed, nonprofits have low levels of reserves and are chronically in a tight cashflow situation. As a result, they have more limited flexibility to respond or survive in times like these. In contrast, many for-profit businesses can lose money for several quarters before they have cash and liquidity problems. It is a rare nonprofit that can survive very long with negative cashflow.

So let’s pull this all together. One: The nonprofit sector has become very large and has grown tremendously in the past two decades. Two: The growth in large part has resulted from a government policy of outsourcing and unfunded mandates. Three: The effect has been accompanied by the weakening of the financial strength of nonprofits brought about

by the desire of philanthropists to leverage their gifts and by the increasing reluctance of our elected officials to fund public services through taxes.

The impact is that a smaller set of people – the major philanthropies – have a larger influence on which services get provided and who gets to receive those services. The key to nonprofits' surviving this unprecedented recession is for the government, and for our major philanthropies, to recognize that they can't be effective if they continue practices that weaken nonprofits' financial resiliency.

One key to resolving this challenge is to recognize that, over the past 20 years, nonprofits have evolved from being fairly independent, in deciding what services are needed, into being suppliers to governments and large donors, who have an increasing role in deciding which services nonprofits will provide. And this is where the lessons of supply chain management become germane.

In a supply chain, the lead company recognizes its dependence on the financial health of its suppliers. In good times, the lead company can compel terms that favor itself over its suppliers. And that is exactly what the government and large donors have done here in Columbus and across the country.

But lead companies also recognize that, in difficult times, the lead company must be responsive to the financial stress it places on suppliers if it is to maintain the supply chain. For Columbus' nonprofits to get through this recession, these lead companies – the City of Columbus, Franklin County, and the large institutional donors we all know – need to reconsider how their rules create financial stress on the nonprofits that are delivering the services the donors want provided.

Here are my five suggestions:

1. **Eliminate match requirements:** If a government, foundation, or large donor wants a service provided, they should pay for 100% of the cost, just as a for-profit contractor would want to be paid in full.
2. **Pay the grant award up front:** Nonprofits are not well enough capitalized to be the banker for philanthropists or governments. Especially now, they do not have the cash to pay their staff for months before receiving reimbursement. Would a for-profit company be able to survive – or would it accept the contract – if it did not receive payment closer to delivery?
3. **Reduce reporting requirements:** Nonprofit managers are spending more and more time filing reports to governments and philanthropies rather than managing services. For-profits complain about SEC reporting requirements; can you imagine if you had the equivalent of 12 SEC's, each requiring their own version of financial reporting, which is the current situation for many of our nonprofits?
4. **Include overhead expenses in grant awards:** Any for-profit supplier would reject a contract that didn't cover administrative and facility costs because such contracts would eventually drive them into bankruptcy. Nonprofits are in a similar position. Heating the building and turning on the lights are essential to

any nonprofit's work, yet local governments and many grantors will not cover their share of these costs.

And, finally, my fifth suggestion: **Make unrestricted grants:** Managing through difficult times requires flexibility. I told you earlier why endowments provide nonprofits with no flexibility. Nonprofits also find that even cash can provide no flexibility because nonprofits often must hold the bulk of their cash in restricted form, which means the cash can be used only for the purpose designated by the donor. It is ironic that some nonprofits with sufficient cash overall, have insufficient unrestricted cash to meet their next payroll. By contrast, virtually all for-profits' cash is unrestricted and usable for any purpose.

So, in the past minutes, I hope I have given you a better idea of how trends in the nation have made the buck stop with our nonprofit sector. Nonprofits have become our public goods provider of last resort but we have handicapped them financially. Because of that handicap, some will fail in the next year and those citizens who depend on their services will be hurt. That is not good for Columbus. There has to be a better way, and I hope I have been provocative enough to prompt you to use some of these ideas to help your favorite nonprofit get through this recession.