

Nonprofit Income Jigsaw

National Center on Nonprofit Enterprise

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Session Plan

- Review the diversity of nonprofit finance
- Discuss theory underlying each source of income
- Consider a framework for developing effective income portfolios

If variety is the spice of life, nonprofits are *really* spicy!

- Many different sources of income
 - Charitable contributions
 - Earned income from fees, sales and ventures
 - Government grants, contracts and reimbursements
 - Investment Income
 - In-kind and volunteer support
- Many different variations within source categories
- Many different *mixes* of income

Variations on Different Types of Income

| Contributions | Government | Earned Income | Investment Income | In-Kind |
|---------------------------------|--------------------|---|-----------------------------|---------------------------|
| Individual giving; memberships? | Grants | Fees for service, memberships? | Returns on endowment | Volunteer & pro bono work |
| Bequests | Contracts | Sales/ Commercial goods and services | Interest on operating funds | Gifts of real estate |
| Corporate and Foundation grants | Reimbursements | Royalties and license fees | Program-related investments | Art and other collections |
| Special events | Credits & vouchers | Rental income | Commercial ventures? | Supplies & equipment |

Aggregate Income Sources by Subsector, 2000

(Nonprofit Sector Research Handbook, 2006)

| | Fees | Gifts | Government Grants | Investment Income |
|-----------------------|------|-------|-------------------|-------------------|
| <i>Health</i> | 85% | 4% | 3% | 3% |
| <i>Human Services</i> | 49% | 19% | 23% | 3% |
| <i>Education</i> | 47% | 17% | 10% | 6% |
| <i>Arts</i> | 29% | 41% | 10% | 6% |
| <i>Religion</i> | 27% | 57% | 3% | 4% |
| <i>Environment</i> | 22% | 51% | 10% | 5% |
| <i>Public Benefit</i> | 21% | 42% | 16% | 7% |
| <i>International</i> | 9% | 68% | 17% | 2% |

More variation

- Nonprofit financing differs not only *by* fields of activity or service but *within* fields of service as well
- We hypothesize (research pending) that variation within fields decreases as categories of service become more narrowly defined

A measure of revenue concentration

- $\sum_j (\text{Revenue } j / \text{Total Revenue})^2$

where j is an index of revenue sources

Arts in Atlanta

| | Gifts | Gov't Grants | Earned Income | Invstmnt Income | Other Revenue | Total Revenue (millions) | RC |
|----------------------------------|-------|--------------|---------------|-----------------|---------------|--------------------------|-----|
| <i>Atlanta Zoo</i> | 39% | 8% | 46% | 7% | 0% | \$19.6 | .38 |
| <i>Atlanta Botanical Gardens</i> | 64% | 0% | 23% | 13% | 0% | \$13.9 | .48 |
| <i>Children's Museum</i> | 32% | 0% | 64% | 4% | 0% | \$2.2 | .51 |
| <i>Atlanta Ballet</i> | 37% | 0% | 60% | 1% | 1% | \$7.3 | .50 |

Arts Organizations in Cleveland

| | Gifts | Gov't | Earned Income | Invest. Income | Other | Total Revenue (millions) | RC |
|--|-------|-------|------------------|-------------------|-------|--------------------------------|------|
| MOCA | 77% | 2% | 17% | 4% | 0% | \$1.7 | 0.62 |
| Apollo's Fire | 56% | 5% | 36% | 2% | 1% | \$0.74 | 0.45 |
| Cleveland Play House | 44% | 6% | 36% | 15% | 0% | \$7.8 | 0.34 |
| Cleveland Institute of Art | 20% | 2% | 72% | 5% | 1% | \$20.6 | 0.56 |
| Western Reserve Historic. Society | 22% | 17% | 24% | 35% | 0% | \$5.4 | 0.27 |

Children/Youth and Recreation in Atlanta

| | Gifts | Gov't Grants | Earned Income | Invstmnt Income | Other Revenue | Total Revenue millions | RC |
|-----------------------------|-------|--------------|---------------|-----------------|---------------|------------------------|-----|
| Boys & Girls Club (Local) | 66% | 13% | 11% | 10% | 0% | \$18.0 | .48 |
| Marcus JCC | 21% | 5% | 70% | 4% | 0% | \$21.1 | .54 |
| Girl Scout Council of NW GA | 13% | 0% | 11% | 68% | 9% | \$14.8 | .49 |
| YMCA (local) | 33% | 17% | 48% | 2% | 0% | \$88.5 | .37 |

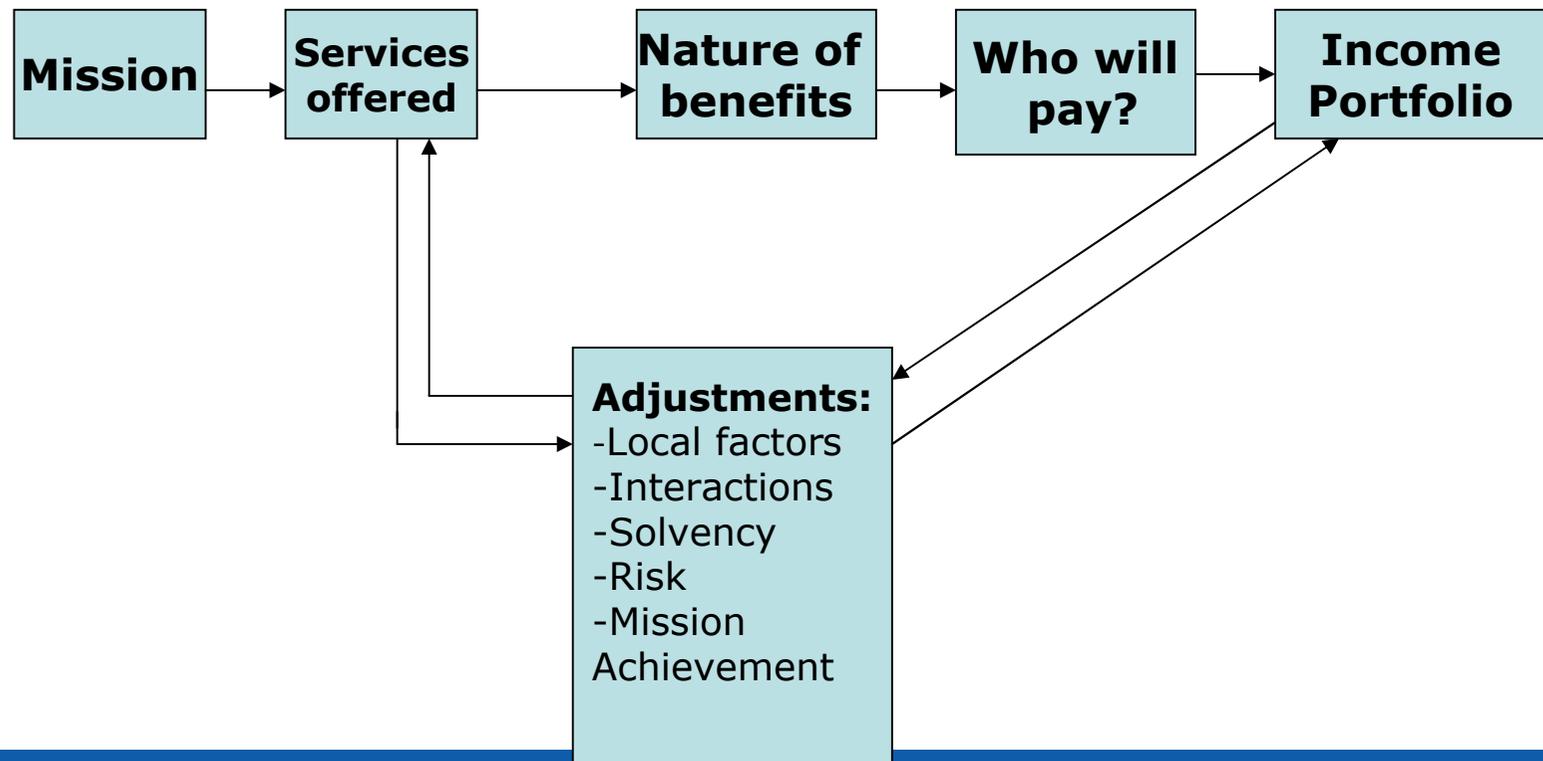
Private Education in Atlanta

| | Gifts | Gov't Grants | Earned Income | Invstmnt Income | Other Revenue | Total Revenue (millions) | RC |
|-----------------------|-------|--------------|---------------|-----------------|---------------|--------------------------|-----|
| Westminster | 7% | 0% | 38% | 56% | 0% | \$72.5 | .46 |
| Olgethorpe University | 10% | 1% | 85% | 4% | 0% | \$26.3 | .73 |
| Morehouse | 8% | 14% | 63% | 15% | 0% | \$94.5 | .44 |
| Mercer University | 10% | 19% | 63% | 6% | 2% | \$203.9 | .45 |

Need for a theory

- No magic bullets – what is the appropriate role for each source of nonprofit income?
- What is the right mix of income support for any given nonprofit organization?

Overall Theory Structure



Sources of Income and the Nature of Benefits

- **Private benefits**
 - **Accrue to service consumers willing and able to pay *fees***
- **Group benefits**
 - **Accrue to specific constituencies associated with causes that donors wish to support *with gifts and grants***
- **Public benefits**
 - **Accrue to the general public, supportable by *public financing***
- **Trade or exchange benefits**
 - **Accrue to organizational partners in a *quid pro quo* relationship**

In what circumstances is each source of income appropriate? Some theory

- Philanthropy
- Government support
- Fee and commercial income
- Investment income

Theory Underlying Philanthropy

- Market Failure: the market will provide inefficiently low levels of public goods and services featuring positive externalities
- Government Failure: where communities are heterogeneous, some groups will demand higher levels of public goods and services with positive externalities than government is willing to provide
- Voluntary provision: donors and volunteers will support the supplementation of government supply – with free riding

Individual giving: group, public and individual benefits

- **Giving associated with communities of interest**, e.g., congregations, alumni, art lovers, nature lovers, families of afflicted individuals, groups experiencing discrimination, ethnic solidarity, etc.
- **Enlightened self-interest**, e.g., inoculations
- **Warm glow**, e.g., public holiday concerts for children
- **Social Pressure**, e.g., giving on boards; giving in church or social clubs; being asked
- **Selective Incentives**, e.g., college football tickets
- **Altruism/Beliefs**, e.g., religious, humanitarian giving
- **Privileged Giving**, e.g., Rockefeller and the Palisades

where reliance on individual giving works best

- In heterogeneous communities where government fails to satisfy everyone's preferences for public goods
- For goods or services that offer a “warm glow”
- In circumstances where social pressure can be effectively exerted
- Where private benefits can be efficiently tied to giving
- Where strong beliefs can be leveraged
- Where there are “privileged donors” who share disproportionately in the public benefit

Institutional Giving –Foundations: exchange benefits

- **Grant-making foundations as nonprofits that outsource their missions**
- **Foundations reflect widely varying preferences and styles of their donors, staffs or trustees**
- **Foundation grants vary substantially in the “transactions costs” they entail: oversight, reporting requirements, and costs and success rates in the application process**
- **Foundations emphasize “leverage”: tend to favor innovation, short term commitment, catalytic role**

When should nonprofits seek foundation funding?

- To help get a project or program started or enhance its development
- Where there is a reasonable match with a foundation's programmatic interests and strategies
- Where goals are short-term or where long term sustainability from other sources is likely
- Where involvement with other grantees or expert foundation staff is likely to enhance effectiveness
- Where anticipated transactions costs - search, cultivation, oversight and reporting, participation in wider thematic programming, managerial involvement - compare reasonably to those of other sources of funds

Corporate Giving: exchange benefits

- **Corporations commonly view philanthropy as an element of corporate strategy**
- **Nonprofits can offer corporations a number of important business-related benefits, including:**
 - **Improved public and community relations**
 - **Enhanced employee morale**
 - **Greater marketing effectiveness**
 - **Cultivating new markets**
 - **Securing needed expertise and knowledge**
 - **Tax benefits**
- **Some (tightly held) corporations do reflect owners' benevolence, expressed through "managerial discretion"**
- **There are both risks and benefits associated with "deep" corporate involvements**
- **Changes in business conditions can make corporate support volatile**

When should nonprofits seek corporate support?

- When there is a “strategic fit” between its goals and the interests of the corporation – a common interest or reasonable *quid pro quo*
- When it can offer special opportunities to the corporation that contribute to its business strategy or philanthropic values
- When the corporation offers special opportunities for the nonprofit to achieve its mission (marketing, in-kind resources, financial support, joint projects)
- Where risks of damage to reputation, or losses due to changes in business conditions, are tolerable

Government Funding: public benefits

- Voluntary provision will entail free-riding and produce inefficiently low levels of public goods and positive externalities
- Government financing overcomes free-riding through taxation, and may be more effective as an agent of redistribution
- It may be more efficient for government to deliver services through support of nonprofits than through direct provision (due to transactions costs, diseconomies of scale, constraints in differentiating services)

Summary: where reliance on gov't funding works bests

- Where government is more efficient at financing by overcoming free-riding through taxation
- Where distributional considerations favor government support for those limited in their ability to pay
- Where positive externalities indicate that government subsidy should underwrite expansion

Earned Income: capturing private benefits

- **Nonprofits can charge for private benefits to the extent that recipients are willing to pay**
- **Charging for private benefits must be reconciled with the loss of mission-related public benefits (externalities, redistributive goals) associated with recipients' unwillingness or inability to pay**
- **Nonprofits can engage in commercial ventures aimed explicitly at consumers who can pay and where mission benefits are secondary**
- **Charging fees can achieve multiple purposes:**
 - Produce revenues
 - Enhance efficiency of resource allocation
 - Contribute to service effectiveness and self-respect

Challenges of relying on fees and commercial income

- Requires finding a competitive niche
- Requires reconciling revenue and mission goals
- Risks mission drift
- Risks crowd-out of charitable donations
- Possible cultural clashes within the organization
- Offers opportunities for market solutions to mission-related objectives, and ties into corporate support
- Requires business acumen – marketing, pricing, planning, entrepreneurship, etc.

Investment Income and Endowments: built upon, but insulated from, benefit provision

- Investment income is often restricted, reflecting the preferences of (benefits associated with) endowment donors
- (Unrestricted) endowment can be built through retained earnings, contingent on successful generation of profitable private benefits
- Endowments sacrifice current for future benefits (reflecting donor benefits/immortality goals?)
- Investment income is only loosely tied to benefits, hence it can insulate nonprofits from “reality” and accountability and provide a false sense of security

Still,

- Endowments produce investment income (fixed revenue) that can help offset fixed costs
- Endowments have a role in risk management:
 - facilitate borrowing and credit worthiness
 - serve as ultimate insurance against catastrophic financial failure
 - Provide additional diversification to a nonprofit’s income portfolio

Management Challenges of Alternative Revenue Sources

- Nothing comes free; no perfect source of income
- Each source has its own costs, potentialities, risks and pitfalls
- Each source requires special management skills

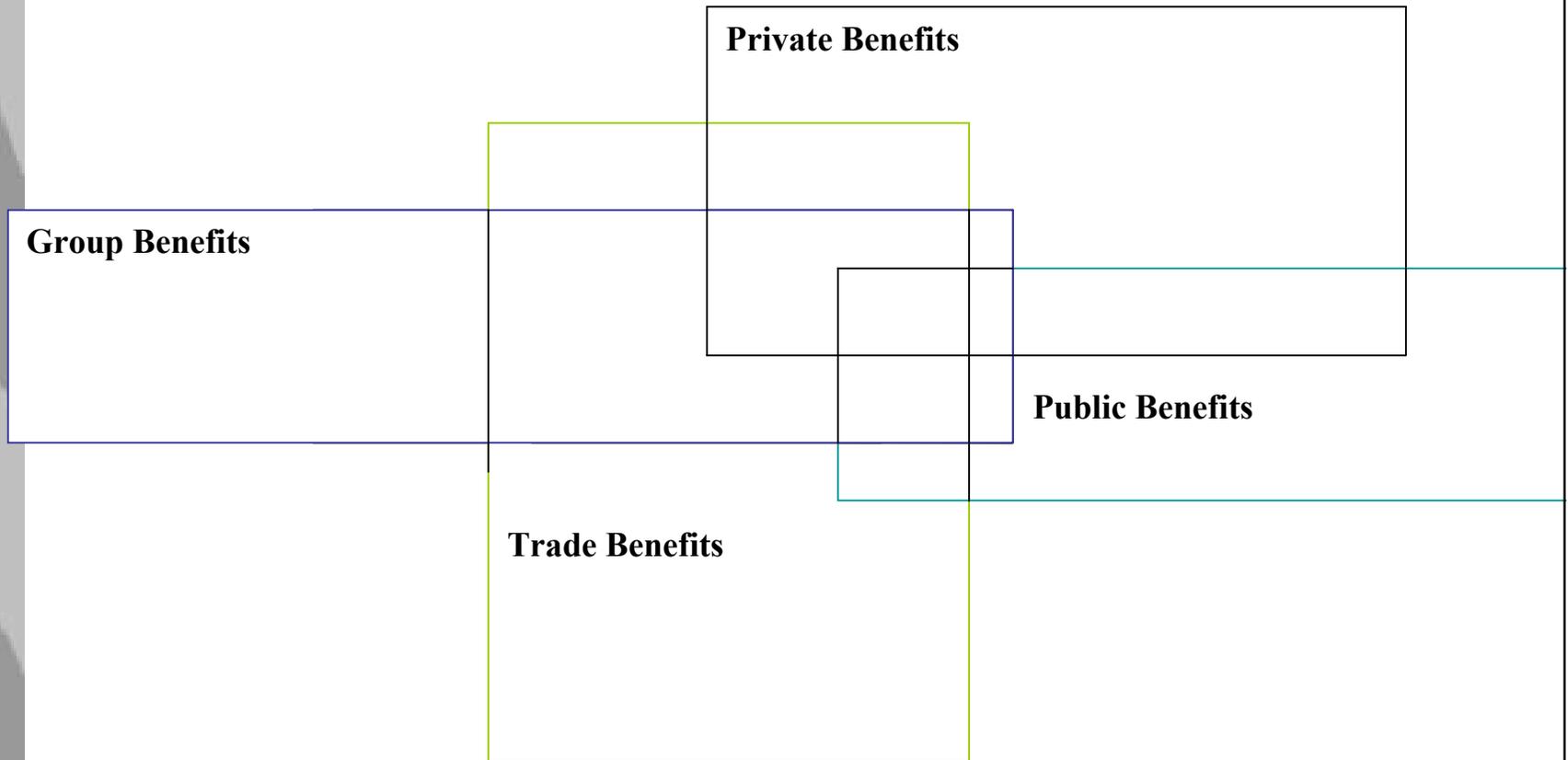
Review: A Working Theory of Nonprofit Finance

- Nonprofits derive income from multiple sources and in many different mixes
- Each source of income has a different conceptual rationale (based in public goods and other theory) tied to the various kinds of benefits provided by nonprofits
- Nonprofits can enhance their income portfolios by appealing to the particular constituencies who receive the benefits of their services
- Nonprofits must adjust their income portfolios to account for financial stability, risk and other factors

Why Diversify Nonprofit Revenue?

- **Mission Effectiveness**
 - **Diversification enables the synthesis of revenue combinations to support an efficient level of service provision**
- **Risk management**
 - **Diversification reduces risk that overall revenue will suddenly decline**
- **Liquidity/Cash flow**
 - **Diversification helps nonprofits match timing of revenue in-flow with expenditure out-flow**

Benefit Combinations and Income Portfolios



Nonprofit services and benefit/income combinations

| Income combo | Example | Why? |
|--------------------------------|----------------------------------|---|
| <i>Fees only</i> | Gift shop | Consumer benefit only |
| <i>Gifts only</i> | Rare disease research | Benefits those afflicted or at risk |
| <i>Gov't only</i> | Offender rehab services | Increases public safety |
| <i>Fees & gifts</i> | Performing arts | Private benefits to attendees; collective benefits to art lovers |
| <i>Fees & gov't</i> | Pre-school care | Private consumer and general public benefits |
| <i>Gov't & gifts</i> | Monitoring environmental quality | Benefits to outdoor enthusiasts and general public |
| <i>Fees, gifts & gov't</i> | University education | Private student, collective alumni, gen'l public benefits |

How diversification reduces risk

- Diversification combines dissimilar income streams into a portfolio
- Favorable deviations in some income streams help compensate for unfavorable deviations in others, reducing overall risk
- The *more components* in a portfolio and the *less correlation between them*, the more effective in reducing risk
- A portfolio reduces (*unsystematic*) risk due to each income stream's unique characteristics but cannot reduce (*systematic*) *market risk* which income streams have in common
- Diversification applies both within and among different categories of income sources
- Adding endowment to the mix introduces an element of flexibility and stability

Revenue Concentration Index - selected results: Chang & Tuckman

| Subsector | mean | standard deviation | Coeff. of variation |
|-----------------------|-------------|---------------------------|----------------------------|
| Arts/Culture | 0.50 | 0.22 | 0.44 |
| Education | 0.67 | 0.22 | 0.33 |
| Health | 0.71 | 0.22 | 0.31 |
| Human Services | 0.65 | 0.23 | 0.32 |
| Total | 0.66 | 0.24 | 0.36 |

Risk management

- Diversification among income sources
- Diversification within categories of income
- Acknowledgement of transactions costs associated with managing diverse sources of income
- Acknowledgement of differences in stability of particular sources
- Reserve funds to cushion temporary setbacks
- Endowments as a last defense against catastrophe and as an asset to facilitate borrowing

So, what proportions of each income source should be in a nonprofit's portfolio?

- ***Basic thrust:*** Estimate income components in proportion to the relative magnitudes of what supporters will pay for the various types of benefits conferred
- ***Portfolio fine tuning:*** diversification and adjustment
 - **Risk management**
 - **Financial solvency and mission achievement: balancing profitable and loss-making activity in multi-product nonprofits**
 - **Potential of alternative sources of income may be influenced by local factors**
 - **Interactions among income streams**

Balancing mission and solvency – product portfolio map

| | High Mission Contribution | Low Mission Contribution |
|--------------------|----------------------------------|---------------------------------|
| Profitable | <i>Stars</i> | <i>Cash Cows</i> |
| Loss-making | <i>Saints</i> | <i>Dogs</i> |

Adjusting for local factors

- Local and temporal economic prosperity as it may affect giving, volunteering, government budgets, and ability to pay for goods and services
- Local culture of giving and volunteering
- Local political culture and attitudes toward taxation and government provision

A Practical, Theory Driven Approach to Nonprofit Income Strategy

- **Income development resembles “deal making”:** seek support in exchange for benefits conferred
- **Start with a service portfolio that addresses your mission**
- **Analyze the nature of benefits conferred by your services:** private, group, public and exchange benefits
- **Seek income support from different sources in proportion with the mix of benefits you confer; justify your requests, proposals, pricing strategies, etc., on this basis – No tin cup!**
- **Make adjustments in your mix to reflect considerations of fiscal solvency, interaction effects, local factors influencing particular sources of income, and management of risk**

Some diagnostic questions

- **What is your mission?**
- **What array of services and activities are essential to effectively addressing your mission?**
- **Who benefits from your work? Which consumers, interest groups, segments of the general public, and institutional partners and volunteer groups?**
- **What are these benefits worth? What can consumers, donors, government and institutional partners or volunteers be asked to pay for them?**
- **How do these prospective payments translate into an overall income portfolio?**
- **What adjustments are required to account for potential interactions among income sources?**
- **What adjustments/additions to services may be needed to address financial solvency? For example, additional earned income projects or new sources of investment income?**
- **What adjustments to the income portfolio are suggested by risk management considerations?**