

*Insights from the National Center on Nonprofit Enterprise*

*Windfalls and Sudden Losses: How Should Nonprofits Respond?*

by Dennis R. Young

Every once in a while, a heart-warming story appears in the news about an unanticipated large gift or bequest received by a nonprofit school, hospital or other charity, from some unlikely donor who lived modestly, saved up his or her money over a lifetime, and decided to give it away to a favored cause or institution. This was the case in Cleveland recently where Cecelia Lucek, a widow who lived a simple life with no hint of great wealth, died at the age of 82 and left the bulk of a \$1.2 million estate to St. Mary Magdalene Catholic High School. The school decided to establish a scholarship fund.

Nonprofits come by financial windfalls in other ways as well. Recent advances in the stock market have produced large gains for nonprofits lucky enough to be invested in shares of companies whose stocks have skyrocketed. This scenario sometimes occurs in magnified form to foundations with undiversified portfolios which just happen to hold shares in the right (donor) company. Of course, the mirror image scenario - the sudden loss of income or asset value - is just as common to nonprofits. A nonprofit that depends heavily on the largesse of a local corporation may experience an unanticipated loss if the corporation suddenly decides to move its headquarters elsewhere. This was the experience of some nonprofits in Cleveland when Sohio was acquired by British Petroleum in the early 1990s and moved much of its corporate operations to London, and again at the end of the decade when BP/America merged with Amoco and decided to move its headquarters to Chicago. Sudden losses have also been associated with dramatic cutbacks in government funding, such as the Reagan budget cuts in social services and the arts in the early 1980s. And, of course, nonprofit organizations with undiversified endowment portfolios are just as apt to experience sudden dives in stock value as they are windfall gains.

The question thus arises: how should nonprofits respond to such sudden changes in economic fortune? How should they adjust the way they allocate their resources? How should they modify the services they offer and the expenditures they make in order to deliver those services?

Much has been written about sudden loss strategies but little about windfall strategies, even though these issues are conceptual twins. Two kinds of loss-related strategies probably are less relevant to windfall situations: In a sudden loss situation, nonprofits can devote effort to finding replacement revenue streams. For example, in the Reagan years many nonprofits turned towards state and local governments to compensate for losses of federal revenue. Nonprofits can also search for ways to become more

efficient in loss situations, streamlining operations and eliminating unnecessary expenses (cutting away organizational slack) without reducing the quality and quantity of services. Such replacement and streamlining strategies do not have equally compelling counterpart strategies in windfall situations. Nonprofits would not necessarily try to find ways to reduce other sources of revenues in order to “compensate” for windfall gains - though this is not completely out of the question. Indeed, some nonprofits may prefer to remain at a given (budget) size or to take the opportunity to disengage from revenue streams that they find less attractive - for example those which may entail obligations or disadvantages they would prefer to avoid. For example, a university might reduce the non-credit courses it offers to the general community if its endowment suddenly increased. Similarly, in a windfall situation, a nonprofit would probably not purposely become less efficient (increase organizational slack) although this may happen unintentionally.

The one strategic approach that has fairly exact parallels in windfall and sudden loss scenarios is adjustment of the organization’s agenda of services and activities, i.e., in what the organization chooses to produce. Deliberations over changes in the agenda are usually framed in terms of “mission” and “priorities”. Organizations ask themselves how they should prioritize their programs in relation to achieving their overall missions. The presumption in this thinking is that low priority activities should be cut back first, when losses occur, or invested in last where windfalls occur, and vice versa for high priority activities.

This is where a simple but key principal of economic analysis is important to apply - the idea of thinking at the margin. Setting global priorities and following these priorities mechanically to make adjustments in windfall and loss situations can lead to inappropriate decisions. Rather than strictly following such priorities in allocating all of the new resources or reducing current allocations in response to a sudden loss, one should make those allocation decisions incrementally, bearing in mind the key question: What difference will the next (or last) dollar (or thousand dollars) make towards achieving the organization’s mission?

There are really two issues to think about here. First, are the organization’s top priorities already well addressed so that more impact would be gained from investing in lower order priorities? And second, assuming that the windfall or cutback is large relative to the organizations overall budget, should the whole windfall (or cutback) be focused on a particular priority so is it best to allocate it over several priorities?

For example, in terms of its community service mission, the top priority of a free health clinic may be its emergency room service, but if that emergency room is already functioning effectively it may not be the best place to invest additional resources. The prenatal clinic may be understaffed and could yield a bigger impact. In short, priorities should be set *at the margin* and continually revised as adjustments are made in the resources allocated to them.

Similarly, in the cutback situation, the relevant question is - where can a (thousand) dollars be withdrawn so that the least harm is done to the mission. If the clinic is operating at top efficiency, all of its programs will be contributing to the mission equally at the margin. If not, some programs may be contributing less than others and should be the first to be pared.

Exceptions to this approach may be necessary to accommodate external constraints on how the new resources may be used or how expenditures may be reduced. For example, it was reported that Ms. Lucek had a preference for scholarships to help poor children so this may have been specified in her bequest. Within such constraints, however, adjusting at the margin will yield the best results.

Windfalls are, ofcourse, happy situations while sudden losses are stressful. In both cases, however, nonprofits will benefits from applying economists' simply way of thinking about resource adjustments - focus on the margin.