



February 15, 2003

Traps and straps for hard economic times

by Avner Ben-Ner

The latest downturn in the economy has hit nonprofit organizations in several ways. Organizations that depend on endowments are experiencing a decline in the availability of funds from lower share values and returns. Organizations that count on gifts from beneficiaries of the stock market are seeing their fortunes decline. Organizations that usually benefit from corporate giving are watching their revenues peter away as corporations struggle to maintain profitability or just to stay afloat. And organizations that receive money from or contract with local or state governments are finding their resources diminish with the rise in government deficits. Meanwhile, the demand for nonprofit services in a number of areas continues to increase.

In this challenging environment, nonprofits are hard pressed to find solutions to their economic woes. Across the board, most nonprofits – soup kitchens, homeless shelters, vocational training schools, private universities, museums, theaters, hospices and hospitals – are facing the same triple threat of diminishing revenues, rising costs, and growing demand for their services. Making ends meet under these circumstances is a greater challenge than most nonprofit executives and policy makers have seen in a long time, and they have every incentive to find straps that can keep nonprofits afloat, and great temptation to grasp at straws that may turn out to be traps.

When confronted with financial threats, managers of all organizations, whether for-profit, nonprofit, or governmental, take two approaches: raise revenues and reduce costs. Panicky managers sometimes forget, however, that revenues and costs are intimately linked: generating more program revenues requires more inputs, particularly labor, which raises costs. Reducing costs in already well-run organizations is generally associated with reduced revenues. However, most organizations are run well only up to a point, and often there is some room for improving efficiency. Navigating around these issues during difficult economic times is quite complex, and managers who proved to be successful leaders during good economic times may fail during demanding economic times.

The most common way for nonprofit managers to raise revenues is to increase program revenue. For an organization that has not served fully its market, this is an obvious opportunity. Similarly, for an organization that has access to foundation and other resources that have not been tapped, this is a great way out of difficulties. For other organizations, which constitute the majority of nonprofit organizations,

there are two possible traps involved with this course. First, in a saturated market, increasing revenues may require higher unit costs than for operations at a lower level. The added revenue may fall short of the added costs and increase the financial stress rather than reduce it. For instance, a performing arts organization may seek to mount additional productions, but the audience will not be there to cover the extra cost; special events at a museum may not attract enough visitors to cover the costs; and special fundraising efforts may actually cost more in direct costs than the contributions raised. If the organization plays it “safe” by contracting with a fundraiser on a tiny margin (say, 9-1 for the fundraiser), it risks losing dear support from its contributors.

Second, in a saturated nonprofit market some organizations may try to engage in or increase their for-profit activities by, for example, enhancing gift-shop operations. Apart from the UBIT consequences, nonprofits face two potential problems involving for-profit operations: 1) nonprofit managers may not be good for-profit operators, particularly when the for-profit activity is not their main expertise, and 2) pursuing profits may change the culture then mission and finally the nature of the nonprofit organization to a for-profit firm. (See Burton Weisbrod’s *To Profit or not to Profit*, Cambridge University Press, 2000).

A second measure intended to deal with financial hardships is to lower expenses, for example, by laying off employees. If the financial difficulties are the result of a decline in demand and thus revenues, cost cutting to adjust the operations of the organization to economic realities is an absolute necessity. In fact, productivity may go up as remaining employees work harder to ensure the organization’s well being and maintain their own jobs. On the other hand, a staff embodies an organization’s knowledge, memory and good will, which are extremely valuable and worth preserving, and substantial staff cuts usually result in depleted organizational capability that is hard to recover.

In addition, organizations may reduce expenses by making operations more efficient, such as outsourcing some activities. Outsourcing administrative and transactional tasks is generally a good practice, and transferring responsibility for such tasks to a specialized organization with deep knowledge and economies of scale may be a source of significant savings. The temptation to outsource expensive internal operations for the promise of competent and inexpensive contractors may prove a mirage, however, especially for smaller nonprofit organizations that can be taken in by sophisticated negotiators who know how to write contracts that protect their own interests and provide services that are hard to evaluate. While there may be the benefit of eliminating certain expenses from the books, outsourcing expensive IT operations or contracting for the essential work of nurses in a convalescent hospital may prove more expensive than anticipated. Accounting tricks aside, outsourcing should be evaluated very carefully as it may be as much a trap as a strap.

Many organizations that have been run by prudent managers and boards have 'rainy-day' funds, which should be used to weather difficult times. Organizations that have endowments should use not only interest and stock appreciation, but also expenditure of some of the principal. Management and boards should consider these approaches if the particular area in which an organization operates is expected to recover in step with the eventual recovery of the economy at large. Such approaches should be considered in preference over large staff reductions and other steps that endanger either the future of the organization or its character.

Individual nonprofits should also consider cooperating with each other at several levels. While recognizing the great importance of competition, sometimes it may be beneficial for all stakeholders, not only the employees and management of an organization, to collaborate across organizational boundaries and even to consolidate, in order to ensure the survival of individual organizational capabilities. Collaboration may take several forms, from the establishment of a shared administrative services organization to an outright merger. Examples of the former abound, for better and worse. The Al Sigl Center for Rehabilitation Agencies, Inc. formed Business Services to provide member agencies in upstate New York with trustworthy and professional services in human resources, telecommunications, purchasing, management information systems, accounting and finance, and fundraising. Hospitals own shared purchasing services, some of which provide great savings to their members, whereas others have turned out to be counterproductive. Increasingly common are mergers among small colleges that take advantage of economies of scale, although at the cost of diluted individual college identities.

During these difficult times for nonprofit organizations, foundations have an obligation that exceeds their immediate goals of promoting certain activities. Foundations that have a broad outlook and a long-term horizon should consider spending down from their endowments and go substantially beyond what the law requires of them. Just as government should be a counter-cyclical spender, increasing its share in the national income when the economy is down and lowering it when the economy is up, foundations that view themselves as more than just stewards of a particular area should also engage in counter-cyclical spending.

For the nonprofit organization that is struggle to keep afloat, there is one recourse that should be regarded, not as the ultimate failure but as another option on the table: fold if remaining true to the organization's mission doesn't seem to work.

A member of NCNE's Research Advisory Council, Avner Ben-Ner is Director of the Industrial Relations Center and Chair of the Human Resources and Industrial Relations Department in the Carlson School of Management at the University of Minnesota.

The National Center on Nonprofit Enterprise (NCNE), a 501(c)(3) headquartered in Arlington, Virginia, helps nonprofit organizations make wise economic decisions.

For more information call (703) 993-4994, visit their website, www.nationalcne.org, or e-mail ncne@nationalcne.org.