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Editors' Note: As the articles in this issue of the Nonprofit Quarterly demonstrate, nonprofits cannot escape the need for careful financial management faced by other types of institutions. But as these articles also make clear, the financial management tasks faced by nonprofits are also different, in both scale and kind, from those facing business and government institutions. The purpose of this article is to explain why that is the case and what the implications are for the financial management tasks confronting nonprofit institutions.

At the heart of the dilemma that underlies all nonprofit management is the fact that American nonprofit institutions operate in the context of a market economy, yet they are not fundamentally market institutions. They are "in" the market but not "of" the market.

Like other institutions, nonprofit organizations must generate income to cover their costs. They have to pay staff, buy supplies, acquire equipment, secure space, arrange fringe benefits, insure themselves against liability and losses, and manage their cash flow. In short, they must engage in all the financial and economic functions of any private institution. Not surprisingly, the techniques of market-based financial management are therefore highly relevant to their financial management tasks.

While they are obliged to operate within the confines of a market economy, however, nonprofit institutions are not true market institutions. They therefore have to take care not to fall too headlong into the embrace of market-based financial management, seductive though it may at first appear.

How Nonprofits are Different

Fundamentally, what makes nonprofits different from other private institutions is that nonprofits have what economists call a different "production function." This is shorthand for the idea that what nonprofits are trying to achieve (to "maximize" in "economics speak") is different from what businesses are trying to achieve. For businesses, the goal of production is to maximize profits. To be sure, businesses sometimes find that to maximize profits they must also do other things--such as treat their employees well, produce good products, develop a reputation for reliability, and even make charitable contributions. But the fundamental purpose of business production remains the maximization of the bottom line. While it is no easy task to determine how best to do this in a fluctuating market environment, this clear production function nevertheless lends a certain simplifying quality to for-profit management.

Nonprofits have a much harder task. While they can hardly ignore the bottom line, it is not the ultimate definition of their success (at least it shouldn't be). Rather, it is organizational mission that defines the "production function" of nonprofits. Managers are supposed to run their organizations in such a way as to maximize their influence on the reduction of hunger, the promotion of scientific advance, the pursuit of cultural excellence, the relief of poverty, the empowerment of the poor, or some other somewhat nebulous objective. This makes the task of nonprofit management both harder and easier than for-profit management—harder in the sense that the connection between means and ends is even more difficult to gauge than it is for businesses; easier in the sense that it's more difficult to tell whether the goals are being met or missed.

This difference in production function is not merely theoretical. It finds tangible reflection in a number of other differences between for-profit and nonprofit enterprises. Let us consider a few of these:

Different Cost Structure

Nonprofits have a significantly different structure of costs than most for-profits. For one thing, nonprofits are not taxed. For another, they tend to be concentrated in labor-intensive industries, so labor costs constitute a larger proportion of costs than in the economy more generally.

Different Revenue Structure

Nonprofits also have different revenue structures than most for-profits, though this difference has narrowed in recent years. Most obviously, nonprofits have access to philanthropic revenues that are generally not available to for-profit firms. This leads to forms of revenue-generation that have no counterpart in the for-profit sphere (fundraisers, pursuit of foundation grants, attraction of wealthy donors). It also creates a class of nonprofit "stakeholders" whose impact on nonprofit operations can easily exceed that of the organization's "customers." More recently, nonprofits have also come to depend heavily on public-sector funding, which creates its own dynamics and expectations. As the forms of government support have grown more complex--through the adoption of third-party reimbursement systems, loan guarantees, and tax subsidies, for example—this has required specialized marketing and financial management skills.

Limited Access to Capital

Nonprofits also differ from for-profits in their access to capital. Capital is income used for long-term investment as opposed to operating income. For-profits can generate capital from two sources not regularly available to nonprofits: from excess income and from the issuance of stock (equities). Nonprofits can sometimes pursue the first of these courses, though some of the major sources of their revenue (government and donors) generally frown on this. The second course--the issuance of stock--is completely unavailable, since nonprofits are forbidden from sharing any profits with a set of owners or directors. What's more, they also are forbidden from distributing any assets they might possess. Under these circumstances, no one would buy stock in a nonprofit, since such stock would essentially be worthless.

This interest-free source of capital for expanding plant or purchasing equipment is therefore not available. Governments have responded to this problem for certain classes of nonprofits (universities and hospitals, for example) by authorizing the issuance of tax-free bonds that attract investment capital. But such bond financing is not available to all nonprofits, and it carries interest costs, albeit at somewhat lower rates than regular market loans. This makes the challenge of raising capital especially difficult for nonprofits and helps explain why for-profits have been able to gain market share in periods of rapidly expanding demand for services.

A Different Human Resource Structure

Nonprofits also have a different human resource structure than for-profits. For one thing, they have access to volunteer labor, which can extend their reach without adding to their labor costs. In addition, they attract workers with a commitment to their missions. Both of these can yield important advantages if properly managed. Recent studies have shown, for example, that nonprofit workforces are far more intrinsically motivated than their for-profit or government counterparts (see "The Content of Their Character: The State of the Nonprofit Workforce," in the Fall 2002 issue of the Nonprofit Quarterly). Indeed, for-profit firms have recently tried to emulate the mission-driven nature of the nonprofit workforce in their own human-resource policies, adopting corporate mission statements and credos and associating their corporations with popular causes in order to build employee loyalty. But neither the effective involvement of volunteers nor the retention of employee loyalty can be taken for granted by nonprofit managers. Indeed, in their haste to adopt corporate financial techniques, nonprofit managers can risk the human resource advantages that are within their grasp.

A Muted Market

Finally, a significant difference exists between the for-profit sector and the nonprofit sector in our accountability relationships--more specifically, “Who needs to be satisfied for us to be paid?”

Simplistically, to thrive over time in much of the business world, institutions must please those who use their products or services. This is a fairly direct relationship. The user is the same as the buyer--and this is the customer. Businesses may be able to fool customers about what they deep down want and even sell them things that are not in their or the world’s long-term best interests, but even if they have many millions of customers, the basic relationship remains very direct.

In contrast, in many nonprofits the buyers can be different from the users.1 The buyer may be a foundation, a government agency or even a base of individual donors--or some combination of all of these, purchasing services that will be consumed by someone else: a community theater attendee, a homeless person. This creates a potential, and too often lived-out, disconnection between what users (constituents) really want or need and what the buyer thinks they ought to have. There may be no, or at the very least a delayed, financial consequence to the nonprofit if it is unresponsive to constituents--beyond satisfying the buyer’s contracted requirements. Thus the voice of the user is “muted.” This also places the nonprofit in the morally vulnerable position of broker--the entity presumably responsible for the translation between what the donor/buyer wants to fund and what constituents really need.

Henry Hansmann pointed out this oddity of the nonprofit economic environment in an article in the Yale Law Journal in 1980, stating: “Because of this separation between the purchasers and recipients of the service, the purchasers are in a poor position to determine whether the service was ever performed, much less performed adequately.” But the problem is far more nuanced than the simple question of whether a contracted service was provided.

Deeper questions exist: Whose interests are served by a specific response to a social problem. The truth is that the worldview of those paying for a particular response may have very little in common with that of the users. The buyer and user may, in fact, have almost entirely different worldviews.

A 1991 study conducted by the Fund for the Homeless at the Boston Foundation looked at this question and tried to trace who was influencing the development of programs. In short, the study found that executive directors of these organizations were having far lengthier discussions with funders than with constituents about how the programs should look and why. Further investigation showed a serious schism between what homeless people considered important both in programming and in policy agendas and what funders considered important.

One area of difference was a solution for good permanent housing. Funders were investing in placing people anywhere that could pass housing code—sometimes many miles and hours of travel from family and friends. Homeless people, on the other hand, wanted “a more circular” setting that included a quality of mutual care—community, in other words. Additionally, in the area of direct services, funders focused on what one participant called “three hots and a cot,” while homeless people thought working to promote longer-term employability was absolutely vital.

Because of the power dynamics between funders and nonprofits, the funders’ frames of reference carried more weight. The views of the homeless people using the programs barely registered.

This muted market problem is not exclusive to the nonprofit sector, of course. For-profits are increasingly entering markets with third-party payers--health care and nursing home care, for example. Because of their profit-oriented “production function,” however, for-profits are not as conflicted as nonprofits by this tension. For them, the only demand that is relevant is the demand that comes with resources attached. They are thus more accustomed to shaping their output to the wishes of the purchaser, regardless of whether it meets the needs of the ultimate consumer.

Conclusion

The above components of the differences generated by being nonprofit in a dominant business market environment are not exhaustive; they do, however, begin to provide a window into the work nonprofits may need to do to adjust their financial management and broader organizational practices to the unique circumstances they face. For example, the discussion here suggests that nonprofits need to take special pains to create reserve funds to finance capital given the limited access they have to investment capital. Similarly, they need to pay special attention to fringe benefit costs given their labor-intensive cost structures. Finally, to address the muted market problem, nonprofits need to create mechanisms that give their customer/users a more effective voice in determining the services they will receive.

Acknowledging these differences and the management strategies required to deal with them, whether at the agency level, at the level of the entire sector or within various subsectors, is essential to the nonprofit sector's long-term survival. We hope this article will help to spark further explorative thinking and action planning along these lines.

About the Authors

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