

Five Ways to Navigate the Fiscal Crisis
By Daniel Stid & Willa Seldon

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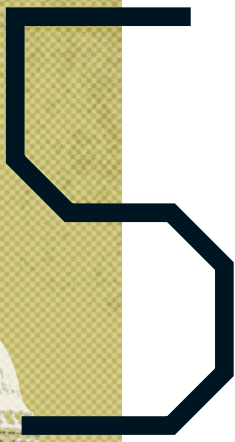
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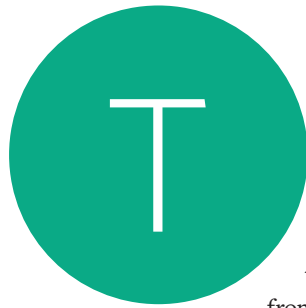




WAYS TO NAVIGATE THE FISCAL CRISIS

How human services nonprofits can stay afloat and advance their missions during a time of government cutbacks.

BY DANIEL STID & WILLA SELDON | ILLUSTRATION BY STUART BRADFORD



The head of a large nonprofit that has been serving children and families since the 19th century and that gets most of its funding from state and local government recently told us: “We have never had the chance to sit down across the table from government and discuss line-by-line what it takes to do the work. They call the terms, they put the dollars on the table, they give the staffing patterns, and you can take it or leave it.”

This is a problem, and it’s only going to get worse. Indeed, for decades now, government has been outsourcing the delivery of human services to nonprofits. Helping homeless youth come in from the streets, bringing meals to the elderly, providing after-school programs for at-risk children—these are among the hundreds of essential services nonprofit organizations are providing every day. The Urban Institute reports that in 2009, US nonprofits received more than \$100 billion from government agencies via contracts and grants for the delivery of human services. For these nonprofits, government funding represented 65 percent of their total revenue.¹ Roughly two-thirds of this funding originates at the state and local level. And increasingly, government agencies not only are outsourcing the financing of these services, they are

also reimbursing nonprofits considerably less than what it costs to deliver them. These organizations are left to cobble together their own resources from other funding sources to make up the difference.


The long-term outlook for human services funding is bleak. The federal government is facing record budget deficits and interest payments to service its rapidly accumulating debt, the rising cost of health care, and the demographic challenge of paying for entitlement benefits for retiring baby boomers. Given that roughly one quarter of state government funding and one third of local government funding come from Washington, D.C., the federal budget squeeze in turn will impinge on human services budgets at these levels. Moreover, state and local governments have their own demographic time bomb to address, in the form of an estimated \$1 trillion to \$3 trillion in unfunded pension and retirement liabilities for current employees and retirees.

This brings us to the questions we take up in this article: How can nonprofits that rely on government funding navigate this increasingly powerful undertow? How can they stay afloat? And can they even hope to make progress? The hard truth is that only a different turn in the political debate over what we owe the most vulnerable members of our society along with a reversal of our nation’s fiscal fortunes

can change this tide—and both appear unlikely in the foreseeable future. The sobering reality is that nonprofits will have to be even more entrepreneurial in their funding models, efficient in deploying their resources, and vigilant in serving their mission to make headway.

Here, at least, there are exemplars. At the Bridgespan Group we have observed in our consulting engagements and workshops with human services agencies across the country—and confirmed through interviews with nonprofit leaders, sector observers, and government funders—that there are clearheaded, highly focused nonprofit agencies using a variety of strategies to sustain themselves financially while continuing to provide high-quality services as they carry out their missions. In an era of “take it or leave it” contracts, some agencies are finding room to maneuver.

COMPETING FOR FUNDING

 Most people are familiar with the problem of monopoly, in which a dominant seller is able to effectively set prices for buyers. We tend to be less familiar with the equally imperfect market condition in which a dominant buyer is able to effectively set the price it will pay to the sellers that want to do business with it. This is called a monopsony, though many refer to it as the Wal-Mart Effect, given how that company systematically leverages its share of the retail market to put the squeeze on upstream producers of consumer goods. When it comes to the market for delivery of social services, government agencies wield something that looks like the Wal-Mart Effect on steroids.

The government agency typically sets the price, and in cash-strapped times like these, may keep it flat or reset it downward as it sees fit. Prices often fail to cover the full cost of those services. In the Urban Institute survey of nonprofit government contractors, 68 percent of respondents identified this failure to cover the full cost of delivery as a problem. According to the CEO of a large New York City nonprofit: “The contracting agency says they want us to have ‘skin in the game.’ Now in reality, government has the statutory responsibility to provide the service. They are contracting out because they think they can get it cheaper.”

Government also leverages its market power to squeeze nonprofits further by changing the terms and driving the execution of these contracts in its favor. The Urban Institute survey also reported that 57 percent of nonprofits responding see government changes to contracts and grants as a problem. Agencies may suddenly be required to have an employee with a master’s degree in social work delivering services that less credentialed employees had previously provided—with no increase in reimbursement to cover the higher labor costs. Similarly, 53 percent of nonprofits see delayed payments as a problem; for cashed-strapped nonprofits, not getting paid on time means struggling to make payroll.²

Faced with deteriorating conditions, why don’t nonprofit service providers simply walk away? The harsh truth is that they can’t. Nonprofits are prepared to accept poor contract prices and endure readjustments in prices and terms and even badly delayed

payments—simply to keep their missions afloat. The CEO of a successful multistate nonprofit bluntly observed of his government counterparties: “They know we are fighting for scraps, so everyone will just jump in to try to get that contract.”

Can high-performing nonprofits escape this “commodity trap” dynamic by delivering better results and thereby stand out from the pack? After all, in private markets, companies often differentiate their products and services and compete on value instead of lower prices. Why can’t high-performance human services providers do the same?

The idea of “performance-based contracts” came to the fore in the 1990s with the reinventing government movement. Such a contract makes some portion of the government’s payment contingent on the nonprofit realizing the desired outcomes, as opposed to the usual focus on accountability for inputs or outputs.³

In theory, under performance-based contracts, nonprofits that are in a better position to hit the outcome targets and track the fact that they have done so would have a competitive advantage and, over time, could increase their share of government funding. In several instances where performance-based contracting has been systematically applied, such as with child welfare services in Illinois or Tennessee, or at the municipal level in New York City, there has been an improvement in outcomes for beneficiaries, sometimes with a reduction in the overall cost of services.

Yet for all the success of performance-based contracting in a few geographies and policy domains, it has not been widely replicated. Among the obstacles are a lack of consensus on appropriate outcome measures, the difficulty and expense for nonprofits to track outcomes, and—not least—the complex challenges that government agencies themselves face in focusing on monitoring and paying for outcomes. As the CEO of a large Los Angeles-based nonprofit told us: “Many of the government funding sources go through the motions of tying funding to outcomes, but it doesn’t really work like that. There is a bit of smoke screen that gives people the impression that it’s going on, but in reality they are still counting heads and counting meals.”

Last, nonprofits compete on influence and relationships. This isn’t necessarily insidious—civil servants often grow to like and respect some of the nonprofit leaders they do business with, and are naturally inclined to keep doing business with them. But politics clearly plays its part. As an entrepreneurial nonprofit CEO who has been repeatedly frustrated in his efforts to expand his agency into new jurisdictions told us: “To get a contract now, you basically have to take it away from someone else. There is no new money on the table. ... If you are better friends with the government, then you will be keeping the contract.” It stands to reason that in a \$100 billion market, there will be a lot of nonprofits that will vigorously defend their interests and their contracts, even when other providers have a better track record of demonstrating outcomes.

One retired state commissioner who had been frustrated in his efforts to bring in new high-performance providers to his state told us that the incumbent nonprofits were largely to blame: “The old crowd is politically powerful. They were fighting tooth and nail for every penny they could get. Our approach was a direct threat to them, and they were able to work their contacts in the legislature like nobody’s business to oppose what we were trying to do.”

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APPROACHES TO STAYING AFLOAT

Given our fiscal reality and the nature of government contracting, optimism may be in short supply now. In the highly constrained world of public funding, can a nonprofit delivering superior outcomes do anything more than take the price, accept the terms, provide the service, and hope that things don't get worse? Do nonprofits have any hope of agency—of having influence or exerting power?

Though we have found nothing resembling a formula, we have seen some nonprofits rising to the challenge as tough times become the “new normal.” These nonprofit leaders are pursuing strategies that enable them to seek and secure public funding while advancing their mission, sustaining their organization, and retaining some room to maneuver in the process. Below are five approaches that seem to be working for the most ambitious human services nonprofits. (For tips on what not to do, see “Managing in a Tough Government Environment: Three Things Not to Do” on p. 40.)

1. Get to strategic clarity | The first step in getting to strategic clarity is to set priorities for where, how, and with whom you seek to have impact. But establishing an organization's mission-critical priorities can be difficult. For larger nonprofits that have grown by taking on a range of contracts across different jurisdictions, government agencies, and policy areas, it is hard to make comparative judgments and set priorities across different kinds of programs and beneficiaries. The quest to win new contracts can take on a life of its own, and nonprofits can slip into what Peter Frumkin has termed “vendorism.”⁴ Indeed, organizations that have solid infrastructure and a reputation for doing the work specified within budget constraints are often recruited by government agencies to take on tasks that may not really be central to the nonprofit's mission.

Some organizations manage to avoid this pitfall by clarifying priorities, articulating the impact they want to be held accountable for, and specifying how they will go about realizing that impact. They define their missions at the next level down in more practical ways. The DePelchin Children's Center in Houston provides adoption, foster care, mental health, teen parenting, and other services from 60 sites across its service area. In addition to an overall mission statement, it developed a set of more specific statements aligned to each of its seven service categories. According to Peggy Pugh, its chief financial officer, these service line-specific missions “enable us to apply that mission statement in making a decision about a given contract.” For example, the more specific statements pointed toward gaps in autism programming and psychiatric services. After conducting a community needs assessment to verify that these gaps existed and that DePelchin was in a good position to help fill them, the agency went looking for government funding to support these services.

The second step in getting to strategic clarity is to understand the true cost of each program or set of services the agency provides. By “true” we mean *direct costs* (frontline staff, rent for service delivery sites) plus *indirect costs* (that program's share of management, information technology, and other agency-wide costs). It may sound simple, but in our experience even the most well-managed organizations have to work hard to understand the real costs of any particular program—especially how to allocate the indirect or so-called

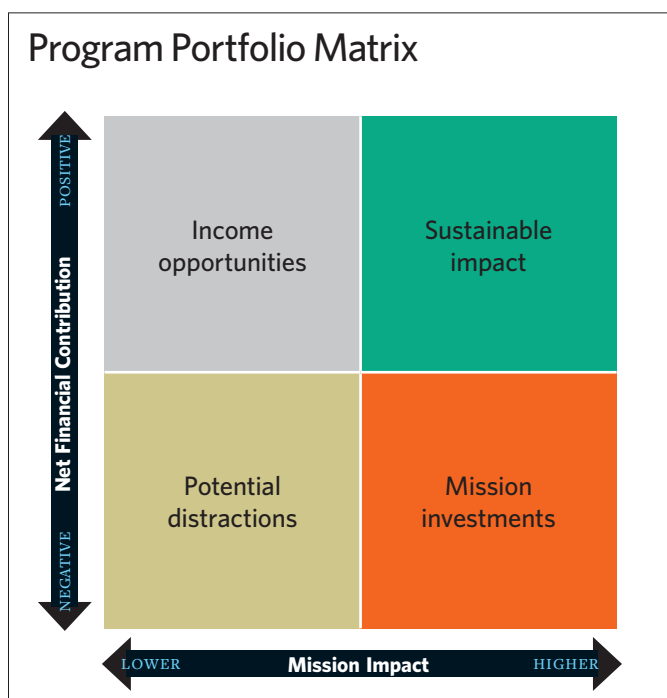
overhead costs that are harder to tie directly to a given program or service but are essential for successful delivery of outcomes.⁵

“This is really about how general ledgers are set up,” Pugh said. “Each division needs to maintain its own P&L (profit and loss statement) and time sheets. You also need to keep track of the units of service they provide. And this is not just the accounting people, but also the operational people. It is important to make program people accountable if they are not within their budget.”

The third and final step in getting to strategic clarity is to make better decisions about whether or how to pursue a particular opportunity for government funding. The key here is for nonprofits to take into account both the potential mission and the financial impact of a given contract.

One simple but nonetheless powerful tool that helps human services nonprofits do this is what we call the program portfolio matrix. As depicted in the “Program Portfolio Matrix” below, the horizontal axis shows programs' relative mission impact and the vertical axis shows programs' net financial contribution. The program portfolio matrix is a snapshot of the organization as a whole, created one decision at a time. In the ideal world, all programs would lie in the upper right quadrant—strongly aligned with the mission and covering their full costs. But human services nonprofits do not operate in an ideal world, and this quadrant is often sparsely populated. Thus nonprofits need to look for opportunities to increase the financial contribution of their mission investments as well as to develop and optimize revenue from income opportunities—provided this doesn't distract from realizing their mission. The trap to avoid, and in our experience a common pitfall, is maintaining a lot of potential distractions—programs that consume more cash than they bring in and do not have much mission impact. Nonprofits should pursue plans to either manage these programs into another quadrant in the portfolio or, if this is not feasible, opt out of them altogether.

Making decisions on how a particular contract will fit in the overall



program portfolio helps organizations make tradeoffs more effectively. Pugh told us: “At times we will take a contract that doesn’t fully cover our costs if it is aligned with our mission and if it positions us for other opportunities; for example, in a different geographic area.”

Another means for good decision making is establishing a formal process that raises and resolves questions about a given contracting opportunity. As agencies grow and diversify their programs, contracting decisions may become decentralized and big tradeoffs are not noticed, let alone resolved. Pugh told us: “People would submit a proposal for a contract without the management’s approval. Now we have a grant-funding meeting once a month. ... We discuss any new grants that come along, and drive the conversation from our operational mission statement.” In DePelchin’s case, the program and finance sides of the house are both involved, sharpening the other’s perspective as well as that of the leadership and team, which ultimately will be accountable for delivering services.

2. Diversify Government Funding Streams | For nonprofits that get the majority of their revenue from government sources, diversifying funding across different government agencies, programs, and contracts can help sustain organizations against declining revenues. In fact, this is a common strategy. Most human service nonprofits hold multiple government contracts. But too often this diversification is driven by opportunism that strains organizations, not a strategic design that plays to their strengths and sustains their missions.

Denise Cross, president of Cornerstones of Care in Kansas City, Mo., described how her organization looks at diversification: “Always be thinking about services you can provide that can be provided in a different way or provided in a different geographic area. ... We developed an approach to support children with behavioral disorders in school settings. It’s an evidence-based curriculum, and we began thinking about who else could benefit from it. So we then took this same approach to children in foster care.” Note that this kind of diversification is *not* about searching for new service populations to qualify for a different source of government funding. In Cornerstones’ case, it is serving the same kids with the same intervention in a different setting.

Many nonprofits that rely on government funds for the majority of their revenue also receive some funding from nongovernment sources: corporations, foundations, individuals. Supplementing

government contract revenue with contributions from other sources may be essential. But as Cross told us, “We are more likely to take a contract that doesn’t cover our full cost if we believe that there is broad community support for the service.” For example, Cornerstones opened an emergency shelter for children removed from their homes because of abuse or neglect. It raised money from individual donors and foundations for startup costs, and secured a government contract to maintain the program. When more kids turned out to be using the shelter than first envisioned, Cornerstones went back to donors to fill in government funding gaps. Cross also explained that her organization has been able to engage third-party payers for some services by “building relationships with insurance companies and structuring our programs so that they feel comfortable paying for them.” For example, insurance may not pay for a 30-day stay, so services can be condensed into a reimbursable three- to five-day stay.

3. Improve Productivity | The drive to improve productivity has long lagged in the nonprofit sector, in large part because of the prevalence of input-based funding and the ambiguity about what nonprofits are “producing.” There are signs, however, that leading human services providers are sharpening their focus on productivity. Consider the observations and experience of Patrick Lawler, CEO of Youth Villages, a Memphis, Tenn.-based human services organization that works with more than 17,000 children in 11 states: “One of the challenges of our field is that we don’t set the price. And most likely that price will not change in 10 years. So every day, you have to say, ‘How can we do this more efficiently and more effectively?’ It’s in our DNA.”

Lawler’s interest in productivity goes back two decades, to a business book titled *Demystifying Baldrige* that he found while browsing in a bookstore. “It taught me about metrics and the use of data to improve quality. I wondered: ‘Why can’t a not-for-profit social services organization manage its quality and costs and processes in the same way?’” Over the years, Lawler’s question has led to a range of breakthroughs at Youth Villages. For example, team leaders realized that typing in case notes was taking up hours of clinician time, so the agency now uses electronic medical records and voice recognition software to allow clinicians to streamline their documentation—reducing time spent on that task by 40 to 50 percent.

Managing in a Tough Government Funding Environment: Three Things Not to Do

CRISIS AND OPPORTUNITY

Don’t squander the chance to make important changes in your organization in operations, leadership roles, or staffing. When significant cuts must be made, across-the-board reductions or leaving vacancies unfilled may seem like the fairest and least painful solution. But in choosing simple solutions, you are postponing hard choices and losing the chance to resolve your budget.

MINDSET

When the going gets tough, don’t hunker down into a negative mindset that causes you to hide or become isolated from potential sources of support. A crisis may turn out to be the best time to ask for help and to mobilize champions. Call on the community, your board—they may be more helpful than you think—and even other organizations, which may be able to take on programs you can no longer support to keep services alive in the community.

STEWARDSHIP

Don’t let desperation guide your decision making and don’t make decisions that are entirely about short-term financial solutions. Examples of bad decisions may include pursuing contracts because you need the money, not because the programs fit with your strategy; and underbidding in a way that starves your organization, burns out your staff, and hurts other providers, creating big problems down the road. (Your best people *will* go elsewhere if you don’t treat them right during a crisis.)

The productivity mindset “is now a big part of what we do and it has transformed our organization,” Lawler notes.

4. Measure Outcomes | Given the nascent state of performance-based government contracting, it may seem odd for this approach to show up on our list. Yet if the goal is to stay focused on mission, then measuring outcomes is essential. All too often, outcomes measurement is something nonprofits feel obliged to do for reporting to external parties. But the real power of measuring outcomes is to drive internal learning about how the work is going and planning how it can be improved. Viewed in this way, rather than being a burdensome quarterly or annual fire drill to comply with funder reporting requirements, outcomes measurement can become a powerful way for leaders and staff to connect with and advance their organization’s mission.

Consider the experience of the Hillside Family of Agencies, which provides a wide range of child and family services in western and central New York. As Hillside CEO Dennis Richardson explained, “We’ve purposely moved to being more data driven, a significant cultural shift for us. It wasn’t that any public or private funder made us do those things. We wanted to know—were we making a difference?”

A great example of Hillside’s progress in outcomes measurement is its Work-Scholarship Connection, a nationally recognized youth development program shown to increase graduation rates and prepare students to enter college or the workplace. The agency began by tracking overall “after the fact” outcomes like graduation. It then moved on to measuring specific leading indicators, such as attendance and credit accumulation. “We can watch a whole cohort of kids as they are going through school, so we can tell if we have a cohort on target or in trouble. And we can do it with individual kids to tailor the services,” says Hillside chief operating officer Clyde Comstock.

Looking ahead, Hillside plans to move its measurement work to the next level with a randomized controlled trial. Richardson sees a clear link between Hillside’s increasingly sharp focus on measurement and its future sustainability. “We started focusing more on measuring our outcomes as a result of our organizational curiosity—What are we doing that actually works?” he observed. “We also have come to believe—looking ahead to the future—that if we couldn’t answer that question, our funding would go to someone who could.”

5. Move Beyond Vendorism | Among the nonprofit leaders we have talked to and worked with, we have noted that the organizations most effective in engaging government are distinguished not so much by a particular set of activities as by a certain mindset. They see the decision makers in government agencies as *customers*. They try to understand their concerns and unmet needs, and they design compelling solutions.

Achieving this mindset isn’t easy. After all, nonprofits tend to see the people and communities they serve, not the government that funds them, as the true customers. Second, government’s power and its habit of wielding it arbitrarily are more likely to create anxiety, resentment, or a sense of helplessness than a customer service ethic. Nevertheless, it is the nonprofits that are doing the selling and the government agencies that are buying the service.

By viewing government decision makers as customers and

working to understand and meet their needs, nonprofits can put themselves in a much better position to inform and shape government requests for proposals (RFPs). “We try to form relationships with the highest level person in the government agency,” said Lawler. “We find out where the leadership’s biggest needs and challenges are, and then look at what services we have that can help them solve the problem. ... We look over every word in new state budgets and the statements made by the governor or head of child welfare services, and put together a plan for how to address the needs identified.”

Richardson and his team at Hillside have developed a multistep co-creation process—intended to occur before an RFP is issued—that involves bringing together the perspectives of families and funders along with their service provider view to improve program design. Even after an RFP has been issued, it may not be too late to keep the conversation going. “We want to position ourselves as a source of solutions for funders,” notes Richardson. “We will provide a proposal that violates the terms of the RFP but that accurately lays out what is really needed. More than once that has led to the RFP being reopened, and we have secured the rebid.”

TAKE IT OR LEAVE IT?



It is dangerous to be right,” observed Voltaire, “when the government is wrong.” In our conversations with leaders of human services nonprofits that are financially reliant on government sources, we have heard a lot about what government is doing wrong in its contracting processes.

We have heard a great deal of anxiety that, in an era of shrinking budgets, the current situation only will get worse, resulting in less funding at all levels of government and more limits on the already limited autonomy of nonprofits seeking to provide high-quality services.

But within this \$100 billion sector—one upon which so many vulnerable people depend—we believe there remains some room to maneuver. The five approaches we have sketched out hardly guarantee success. The most thoughtful strategy in the world can still come to grief when the government suddenly delays yet another payment or develops an RFP to solicit competitive bids for a service that your organization currently holds the contract to provide. Yet within the system’s numerous constraints, nonprofits have been employing these approaches to get beyond a take it or leave it relationship with their government funders—keeping their eyes on their mission and doing the best they know how for the people and communities they serve. ■

The authors dedicate this article to the memory of Peter Goldberg. He inspired us to undertake it and helped us at each step along the way.

Notes

- 1 Elizabeth T. Boris, Erwin de Leon, Katie L. Roeger, and Milena Nikolova, “Human Service Nonprofits and Government Collaboration: Findings from the 2010 National Survey of Nonprofit Government Contracting and Grants,” Urban Institute, 2010: 5.
- 2 Boris et al., “Human Service Nonprofits and Government Collaboration,” 13.
- 3 See David Osborne and Ted Gaebler, *Reinventing Government* (New York: Penguin Books, 1993); and Lawrence L. Martin, “Performance-Based Contracting for Human Services: Does it Work?” *Administration in Social Work* 29(1), 2005: 63-77.
- 4 Peter Frumkin, *On Being Nonprofit: A Conceptual and Policy Primer* (Cambridge, Mass.: Harvard University Press, 2002): 167-169.
- 5 Nonprofits can find a free cost analysis toolkit at: <http://www.bridgespan.org>.