

To Fee or Not to Fee? (And Related Questions)

by the editors

Editors' note: This article is adapted from the 2005 book *Effective Economic Decision Making by Nonprofit Organizations*, which was produced by the National Center on Nonprofit Enterprise and the Foundation Center. This article was originally published in NPQ, summer 2004, volume 11, no. 2, but its wisdom still holds true today.

WHY WOULD TAX-EXEMPT organizations, which have some freedom from the strictures of the marketplace, willingly subject themselves to satisfying the market for even a part of their budgets? Not merely to get more money, it turns out; but since market failure is a common rationale for why we need nonprofit organizations and why they are free from paying most taxes, nonprofits have to act wisely in setting fees.

Fees for service have been charged by nonprofits for years, but research shows that this is becoming an increasingly large proportion of nonprofit budgets. It behooves us, therefore, to know what we are doing when thinking about whether and how to price our services to our constituents. This article describes four of the considerations cited by Oster, Gray, and Weinberg, including the following:

- whether to charge fees;
- how to start or increase fees;
- sliding scales; and
- bundling services.

These are critical considerations in pricing a program, but they are not the only factors. Readers interested in the practical matters of combining fixed

with variable and semi-variable costs as aspects of pricing programs should also refer to the article in the Spring 2003 issue of the *Nonprofit Quarterly* entitled "Is There Enough Overhead in Your Grant?" (www.nonprofitquarterly.org/section/396.html).

To Charge or Not to Charge?

The most powerful argument in favor of charging fees is the discipline of the marketplace: that fees increase accountability to the people receiving services. Getting a third-party payer involved (in this case we use the term *third party* to denote a foundation, health-care insurer, or government, etc.) in any transaction can divert the accountability so that the organization is more focused on the requirements and satisfaction of the third-party payer than on the needs of the recipient. The advantages of relying on revenue from users is that an organization will likely serve users better when its financial/institutional success is directly tied to user satisfaction.¹

The nonprofit sector's access to third-party funding mechanisms means that for some organizations, it may be financially viable to have no charges for

services—but this doesn't mean charging is out of the question. As Centro Presente, a Boston-based Central American organization discovered, it can be worth further examination even where the organizational tradition is to depend primarily on grants and contracts. When Centro Presente started, many of its constituents were newcomers to the United States and, indeed, had little money to spare.

Over time, the organization was faced with cutting back on its core programs because there was less grant money available to support its activities (legal services to immigrants and advocacy on immigration-related issues). The organization began conversations with its constituents to engage them in revisiting the organizational model. These conversations revealed that sufficient numbers had progressed to gainful employment and were more than willing to pay the organization for services, as long as it provided what they really needed. This change increased revenue and brought the organization closer to the needs of its constituency. Centro Presente still receives grants but is less dependent on them; and it has a healthier, more sophisticated, more straightforward—and

therefore less encumbered—planning process.

Still, sometimes user fees are not practical given the organization's mission. Many nonprofits, such as Mothers Against Drunk Driving, advocate for things that are socially beneficial but for which there is no direct service to individuals on which fees could be levied. Even though the population as a whole can be said to benefit from MADD's work, the organization has no ability to restrict its benefits to the people willing to pay. In fact, the most appropriate revenue source (and the only one available) is voluntary contributions from people who understand that others, unable to pay, also benefit.

"Sometimes charging a fee makes no practical, economic sense," as the article "Pricing in the Nonprofit Sector" notes. "One example of this is when the cost of collecting fees would exceed the revenue raised from such fees." The authors note that this happens most commonly when "the costs of monitoring usage are very high, for example in a recreational area with no natural fences."

The authors go on to say the following:

Numerous studies have suggested that in many circumstances, forcing clients to pay at least some fee, however modest in its revenue-generating properties, creates buy-in for those clients and can be mission-enhancing. In instituting a fee, we have fewer clients, but higher success rates with the clients we do have.

In an experimental study, Yoken and Berman (1984) demonstrate that before psychotherapy even began, clients who expected not to pay for treatment anticipated gaining significantly less from their sessions than those who were told they would be charged a fee. In a field setting, Kotler and Roberto (1989) reported that patients avoided a newly established free clinic in a South

American hospital because "they were not convinced of the quality and attention they would receive in the hospital" (p. 175). As a result, the hospital decided to charge a fee and the number of patients increased. However, it should be noted that when clients have a stronger basis for judging product or service quality, the role of price as a cue for high quality is more limited.

There are also times when charging some fee helps to preserve the dignity of clients served. The Cleveland Jewish Community Center, for example, recently introduced a transportation program for seniors, providing rides for doctor visits, shopping and other activities. Each senior paid "\$1 per leg." Revenue raised in this manner is relatively modest, for there is no real congestion issue, and the service is not intended to change client behavior. The fee clearly does have a role to play by signaling to seniors that they contribute to the program, and that it is not strictly charity. For populations that are "newly needy" charging a modest fee may be much preferable to no fee at all.

Fees are a good fit in the following situations:

- collecting fees is practical;
- access to the service among the intended audience is not cut off through the charging of those fees;
- accountability to beneficiaries would be significantly augmented; and
- the central function or core mission is not subverted. This subversion can occur in several ways, including displacement of primary beneficiaries by more affluent customers, and mission drift to more lucrative pursuits through inattentive managers.

It is wise for managers to think through alternative long-term scenarios

and monitor consequences.

How to Transition to Charging Fees

It is one thing to launch a new service with a price attached; it is another and more difficult proposition to attach a price to a service originally provided for no fee. On the Internet, there is a variety of hard-gained experience to support this. "Once people are accustomed to receiving something for free, it is very difficult to get them to pay for it."

Some organizations have found that they can make a gradual transition to charging fees if they

continue to offer a version of the product free, while offering a preferred option at some price. Arts organizations that begin by offering free concerts will find it easier to introduce pricing if they maintain some free seats (or some free performances). The Kennedy Center coupled a substantial increase in admissions fees with increased attention to free performances. Health clinics that initiate co-pays for service might limit those co-pays for certain essential health services.

The overriding suggestion in this chapter on making the transition from no-cost to cost-based services is this: It is easiest to institute a price for an already-existing service when there is a significant upgrade or change in that service, the key word being *significant*. A related caution is that when a new or redeveloped service is initiated, there are frequently startup costs greater than planned. Organizations should budget cautiously for development, evaluation, and fine-tuning of the program as well as for development costs for new financial controls and the installation of mechanisms to collect and process payments.

Considerations for Sliding Scales

Nonprofits are active users of differential pricing, usually in the form of sliding scales, but they are not particularly scientific in their approaches. Theoretically, a sliding scale carries with it the potential for alienating clients who are paying full freight. But for many nonprofits, the advantages to differential pricing are clear: it provides access to those who might otherwise be excluded; it allows for income diversity among program users; and it provides a larger market for the service. Oster, Gray, and Weinberg assert that the apparent key to success in establishing and maintaining a sliding-scale fee structure is transparency combined with voluntary participation.

According to Oster, Gray, and Weinberg, there are some good examples.

A small preschool program in New Haven charges day care prices on a sliding scale related to voluntary reporting of parental income and supported by an explicit ideology of inclusion. In these cases, there is a kind of voluntary or at least cooperative price discrimination and some attempt to promote buy-in of the principle of differentials. Some museums take an intermediate stance, treating admissions fees as voluntary donations, but listing a “suggested” fee. For modern-day colleges, the picture is rather different. For many in the college world, differential pricing is a tool that improves institutional quality for all students, by allowing colleges to accept a student population without regard to ability to pay. Nevertheless, tuition differences are imposed, not chosen, and the ideological and practical importance of these price differentials, however clear they are to administrators, are not always widely embraced by parents. The result, in

some colleges, is a growing resentment and gaming of the system.

For nonprofits that want to practice differential pricing, the lessons are clear: The more cooperative or voluntary such differentials appear, the less resistant clients will be to them. When differentials are imposed, rather than chosen, the nonprofit has a burden to convince clients of the value of the differentials in terms of product improvements for everyone. Winston and Zimmerman (2000), for example, suggest that colleges remind parents that even those students who pay the full \$31,000 tuition are paying only a portion of the true total costs of an education. In this way, the point is made that in organizations supported in part by donative funds and/or endowments, each client is typically subsidized, and it is simply a question of how deep those subsidies are for different people. Again, in the college setting, making the case for the role of diversity of all sorts in improving the college experience for all students is vitally important in reducing resistance to pricing differentials. For organizations like hospitals and arts organizations, with substantial infrastructure or fixed costs, differential pricing may help to expand the audience in ways that lower the overall average production costs.

Considerations in Bundling Services

Product bundling is the practice of offering groups of services as packages, with a package price. The authors pose the question “Should an organization offer discounts to clients who buy in volume, or to those who buy a range of the services offered?” The authors continue:

Such discounts are common in both the for-profit and nonprofit world. Theatres offer subscriptions to most or all

of the plays offered in a season. In these subscriptions, theatres offer a series of plays for a price that is slightly lower than the price of the separate tickets, pushing patrons to attend a play they might otherwise eschew. Museums offer memberships, enabling patrons to pay a fixed up-front fee and then visit the museum whenever they want for no fee. These packages are especially useful in settings in which the incremental cost of adding client use is very small. When we offer a package, we are encouraging usage, because once the fee is paid, the added cost of attendance at the event is zero. For a museum with lots of open space, or a theater with empty seats, the demand expansion gained through product bundling can be very advantageous for both mission reasons and economics. Behavioral economists have found that these bundled subscription fees or memberships are especially attractive to customers when the products or services are meritorious goods. For high-end theater, opera, intellectual journals, and the like, customers buy subscriptions in part as a way to “force themselves” to use more of the product than they might episodically choose (Ryans and Weinberg 1979).

When clients differ in terms of their needs, the choice between fixed price and à la carte becomes more interesting. In this case, offering prices for each of the pieces lets clients pick and choose, and this has considerable advantages. As a consequence of this pricing strategy, there will likely be differences among your clients in the way each uses services. On the other hand, the nonprofit may actually want to use the price structure to try to induce more homogeneity among clients.

Bundling can help organizations in the service of their missions in other ways as well. Judicious combinations

of plays can help theaters to use the lure of popular plays to ensure attendance at more obscure choices. This bundling both fills empty seats at these plays, and educates audiences about new genres. For this reason, the components of series are usually carefully chosen to include some pieces that would have trouble standing on their own.

Bundled prices that promote homogeneity may serve an ideological function as well. Consider a community center in a diverse neighborhood that offers a range of weekend and after-school activities. Pricing each activity differentially has certain appeal, particularly when some programs are likely to be oversubscribed and when those programs vary by costs. On the other hand, offering all, or at least most, of the programs for a fixed, single membership fee, promotes economic diversity in the program base. For many nonprofit organizations, this non-sorting effect may be the dominant consideration in choosing the à la carte or fixed price scheme. However, as Aansari, Siddarth and Weinberg (1996) demonstrate in a study of performing arts organizations, bundling often works somewhat differently in the nonprofit sector. The typical nonprofit arts organization prefers bundles with larger numbers of events, for example, than the for-profit. Bundling is thus used in part to expand volume, as well as to expand profits. As in the for-profit sector, most nonprofits employ strategies of mixed bundling, selling both single tickets and subscriptions, and subscriptions have added value to the nonprofit. This may well be in part because subscription sales often lead to charitable giving.

Nonprofits Embrace Fees

Since more and more nonprofits are considering undertaking some

revenue-generating activity, when and how to charge fees and how to think about and manage the pricing and capturing of these fees should clearly be a strong and consistent thread of conversation among nonprofits. This article has raised considerations in four broad areas: to charge or not to charge; how to transition from a no-fee to a fee-based structure; sliding scale fees; and bundling services. These tactics can be considered opening salvos in a longer consideration of fees in the context of nonprofit work.

ENDNOTES

1. See Ruth McCambridge and Lester Salamon, "In but not of the Market: The Special Challenge of Nonprofit-ness," *NPQ*, vol. 10, no. 1, spring 2003.

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