



# Nonprofit Contracting:

## *Breaking the Cycle of Public Underinvestment*

by Mary Kate Bacalao

**Editors' note:** This article is paired with Patrick Rooney's important reveal about the problems in the current tax code around charitable deductions and argument for our championing of the universal charitable deduction as policy, because they are both about public expenditures on civil society. As most readers recognize, the entire nonprofit sector is subsidized through tax exemption on the assumption that we are serving the greater good. Additionally, government money raised through taxes comprises approximately one-third of revenues flowing into the nonprofit economy (per the Urban Institute in 2015). But some years ago, famed fundraising guru Kim Klein suggested that nonprofits' lack of interest in our tax structures exhibited a shortsightedness bordering on malfeasance. Taxes, Klein posited, represent not only the government's revenues but also many of its expenditures, since tax breaks and incentives are expenditures as much as payments into, for instance, privatized outsourced services provided through nonprofits. Both types of payments and how they are handled—whether they truly serve the greater good—exhibit the overriding values system in play. Some might suggest that it is all part of the same neoliberal tangle. We make this connection explicit to encourage readers and the sector's infrastructure to do a better job of building a tax agenda that includes a rewrite of the value assumptions that cause problems like those cited here.

**N**ONPROFIT FINANCIAL PERFORMANCE MAY NOT seem high stakes, but it can be a matter of life and death when people lack access to the emergency services nonprofits provide. Consider homeless youth in San

Francisco: those without shelter have a mortality rate that is ten times higher than their peers with a safe place to sleep.<sup>1</sup> Nonprofits exist in part to redress inequities like this, but their ability to do so is constrained by the restrictiveness of some public money—which can limit a nonprofit's capacity to buy essential services for the people who need them most. For unsheltered youth, the question is, how easy is it for a line item in a public budget to become a service, such as an emergency shelter stay?

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Too often, the answer is: not easy at all. Line items in federal and state budgets become line items in nonprofit budgets before they become essential services. And public funders dictate

down to nickels and dimes how taxpayer money must be spent across each line item. In the case of a licensed youth shelter, there are strict upper limits on how much public funders will pay to staff the facility and how much per square foot the nonprofit can invoice for rent. Regulations may stipulate that a nonprofit can buy towels, but not bath mats, for shelter bathrooms, or that food can be reimbursed at \$2.50 per breakfast per youth—an amount that wouldn't buy coffee for the budget administrator.

It is a failure of public priorities that lifesaving services can be so prescriptive about what young people eat for breakfast. It shows an equal lack of priorities that such burdensome regulations come with only partial payment for nonprofits doing the lifesaving work. Government contracts for social services pay about 70 cents on the dollar of a nonprofit's direct program expenses, and less than 50 cents on the dollar of its indirect expenses—the overhead required to coordinate the invoicing for towels but not bath mats, so that the funder pays the invoice, so that the youth shelter doesn't run into deficit spending, so that the nonprofit can continue operating it, so that fewer youth will be forced to sleep in the streets, and so on.<sup>2</sup>

Nonprofit leaders shouldn't assess nonprofit financial performance without this context. According to a recent report by the Alliance for Strong Families and Communities and the American Public Human Services Association, nearly one in eight human services nonprofits is technically insolvent or unable to pay its debts; nearly three in ten nonprofits don't have cash on hand to cover a month's worth of expenses; and nearly half of nonprofits report a negative operating margin, meaning they're losing money multiple years in a row.<sup>3</sup> The financial straits are most dire for nonprofits operating housing and shelter programs, like the youth shelter described above: one in three is insolvent, more than seven in ten don't have cash to pay their debts, and six in ten report losing money over a three-year operating period.<sup>4</sup>

## The Budgetary Ecosystem

This isn't an accident or a case of pervasive incompetence. There's a key causal link between a nonprofit's financial performance and the

budgetary ecosystem in which it operates. Government budgets have grown this ecosystem with artificially low investment levels and overly burdensome regulations that anchor what nonprofits and other stakeholders (private foundations) consider “market” across the sector. Government agencies decide what counts as expensive—\$500,000 is considered a lot of money in social services, but it might buy a single statue in a public park—and also what counts as restrictive. This directly affects a nonprofit's financial bottom line and its ability to invest and reinvest in delivering impact over time.

Central to a nonprofit's ability to reinvest is its ability to generate a *surplus*—the nonprofit word for profit. A surplus is the key to a nonprofit's long-term financial health: it generally comes from extra money without restrictions that can go where it's needed most. In an underfunded, overregulated budgetary ecosystem, money that would have been surplus most often goes to the gap between what programs cost and what contracts pay. If it's not enough (or barely enough) to plug the gap, the nonprofit loses money (or breaks even), and nonprofits that lose money or only recover costs will never generate a surplus for reinvestment. All they can do is pay today's expenses and hope they're not in the red tomorrow.

This tension surfaces in the audited financial statements in several ways: in the nonprofit's cash flows, the sizes and types of its liabilities (what it owes), and its changes in net assets over time (the assets left over when the liabilities are subtracted). The nonprofit needs an equilibrium between cash going out and cash coming in, so that it can grow reserves for unexpected setbacks and maintain liquidity to pay short-term debts as they become due. This preserves the equilibrium between assets and liabilities, keeping net assets stable and maintaining the nonprofit's overall solvency. These are the levers that tip a nonprofit toward or away from financial health from year to year.

But it's clear from the budgetary ecosystem in which nonprofits operate that they're not supposed to generate surplus (exhibit A, according to Susan Dreyfus, president and CEO of the Alliance for Strong Families and Communities, is

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the word *nonprofit*).<sup>5</sup> Nonprofits are supposed to spend down every line item to the nickel on their program budgets, leaving no money on the table to reinvest in other needs. (If nonprofits do leave money on the table, funders almost always deobligate the funds, or take them back.) The imperative to fully utilize funds is antithetical to the goal of generating surplus, and surplus is key to nonprofits' long-term financial health. It's reasonable to conclude that public investment is designed to make social services available, but not in a viable way.

This perpetuates a vicious cycle in which public funders underinvest in nonprofits, which underperform financially, which justifies continued underinvestment in the name of efficiency. It's a game of misdirection on a massive financial scale—the management consulting firm Oliver Wyman and other experts calculate that it would take \$40 to \$50 billion to restore U.S. nonprofits to solvency—and the worst part is that real people's lives hang in the balance (remember the mortality rate of young people without access to shelter beds).<sup>6</sup> If public agencies invested sustainably in social services, and if public dollars were less restrictive, nonprofits could translate public investments into a stable service infrastructure, with the potential not only to save lives but also to produce better life outcomes, creating wealth and reducing health-care costs substantially.

### Advocating for More

Breaking the cycle of public underinvestment will require collective action and structural reforms to nonprofit contracting. *First, the sector must address artificially low investment levels.* Government agencies must put real money on the table, and nonprofits must negotiate for full costs. These include program costs, such as the costs of operating the youth shelter in our example, but they also include agency costs, including (but by no means limited to) the costs of measuring impact: Do shelter residents exit to stable housing? Is the nonprofit ending homelessness or merely interrupting it with temporary shelter beds? Public funders should want—and they should pay for—the answers.

*Second, the sector must address overly burdensome regulations.* Nonprofits must comply with the major rules of the road—generally accepted accounting principles (GAAP), for example—but a narrow focus on compliance diverts resources away from delivering outcomes. As Claire Knowlton, director of consulting at the Nonprofit Finance Fund (NFF), writes, compliance and outcomes can be “at odds.”<sup>7</sup> Compliance looks backward: did the nonprofit invoice properly for the youth shelter's bathroom towels and other allowable costs? Outcomes look forward: how can the nonprofit use its shelter budget to help young people permanently end their homelessness? Compliance plays a role—it must deter mismanagement—but public funders should incentivize and pay for outcomes.

*Third, nonprofits can and should act individually to disrupt the cycle of public underinvestment.* Nonprofits can use sector-wide trends to tell bigger financial stories than the results presented in their quarterly reports and yearly

### RECOMMENDED READING

- Oliver Wyman and SeaChange Capital Partners, *A National Imperative: Joining Forces to Strengthen Human Services in America—2018* (Alliance for Strong Families and Communities and the American Public Human Services Association, 2017).
- George Morris et al., *The Financial Health of the United States Nonprofit Sector: Facts and Observations* (Oliver Wyman, SeaChange Capital Partners, and GuideStar, January 2018).
- Thomas R. Ittelson, *Nonprofit Accounting & Financial Statements: Overview for Board, Management, and Staff*, 2nd ed. (Cambridge, MA: Mercury Group, 2017); and its companion, Thomas R. Ittelson, *A Picture Book of Nonprofit Financial Statements* (Cambridge, MA: Mercury Group, 2017).
- Thomas A. McLaughlin, *Streetsmart Financial Basics for Nonprofit Managers*, 4th ed. (Hoboken, NJ: John Wiley & Sons, 2016).

audits. Financial reports are important: they can warn a nonprofit that its youth shelter has more cash going out than coming in—a red flag for the shelter’s (and the agency’s) financial health. But reports lack the context that sector-wide trends can help provide. The shelter may be underfunded and overregulated, with a contract that imposes costs out of proportion to what it pays. This may speak more to the nonprofit’s budgetary ecosystem than to the shelter’s quality of financial management.

This distinction—between how well a nonprofit operates a shelter and how well its regulatory environment allows it to operate—can shift how we understand nonprofit financial performance and how we advocate for more (and more permissive) public dollars. And that can make all the difference for the unsheltered young people who need the beds.

#### NOTES

1. Maria L. La Ganga, “Mortality rate for homeless youth in San Francisco is 10 times higher than peers,” *Guardian*, April 14, 2016, [www.theguardian.com](http://www.theguardian.com)

[/us-news/2016/apr/14/san-francisco-homeless-youth-ten-times-more-likely-to-die](http://us-news/2016/apr/14/san-francisco-homeless-youth-ten-times-more-likely-to-die).

2. Oliver Wyman and SeaChange Capital Partners, *A National Imperative: Joining Forces to Strengthen Human Services in America—2018* (Washington, DC: Alliance for Strong Families and Communities and the American Public Human Services Association, 2017).

3. Ibid.

4. Ibid., 32.

5. Speech given by Susan Dreyfus, president and CEO of the Alliance for Strong Families and Communities, at Seneca Family of Agencies, Oakland, CA, on June 26, 2018.

6. George Morris et al., *The Financial Health of the United States Nonprofit Sector: Facts and Observations* (New York: Oliver Wyman, SeaChange Capital Partners, and GuideStar, January 2018), 1.

7. Claire Knowlton, “Why Funding Overhead Is Not the Real Issue: The Case to Cover Full Costs,” *Nonprofit Quarterly* 22, no. 4 (Winter 2015): 71–76.

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