



Moving beyond Mission: *Effectively Funding the Nonprofit Organization*

By Carolina Reid

In his new book, *The Housing Policy Revolution: Networks and Neighborhoods*, David Erickson shows how the construction of affordable housing has moved away from the federal government towards a network of state and local governments, nonprofits and grassroots organizations, the private sector, labor unions, foundations, and churches. Each of the nodes of the network brings its own expertise and resources to the table. Banks, for example, provide loans and capital through their CRA-motivated loans and investments. Foundations often provide funding for research and development, backing pilots and demonstration projects that can help to illuminate what types of housing strategies best support lower-income households.

At the heart of this network, however, is the nonprofit organization. For the most part, it has been nonprofits in the form of grassroots community groups, community development corporations, community development finance organizations, and national intermediaries that

have been the ones on the ground pouring the concrete and supporting lower-income tenants with a wide array of services. Indeed, the growth of the nonprofit sector in the United States in the last 40 years has been formidable, and today the nonprofit sector contributes more than \$322 billion in wages, with a workforce that outnumbers the combined workforces of the utility, wholesale trade, and construction industries.¹ As Erickson and others have argued, with their small scale, flexibility and capacity to engage grass-roots energies, nonprofit organizations have not only been able to fill the social service gaps that were once the purview of the federal government, but to do so in a way that is more effective and efficient.²

Yet Erickson's book also points out two major challenges for this network: adequate funding on the one hand, and capacity on the other. These two challenges are deeply intertwined, and the current recession has placed both of them into stark relief. On the funding side, the recession and financial crisis has hit nonprofits particu-

Figure 1
Number of Nonprofit Organizations in the United States, 1998 - 2008

Type of Organization	1998		2008		Percent Change
	Number of Organizations	Percent of All Organizations	Number of Organizations	Percent of All Organizations	
501(c)(3) Public Charities	596,160	51.5%	974,337	63.4%	63.4%
501(c)(3) Private Foundations	70,480	6.1%	115,340	7.5%	63.6%
Other 501(c) Nonprofits	491,391	42.4%	446,457	29.1%	-9.1%
All Nonprofit Organizations	1,158,031	100.0%	1,536,134	100.0%	32.7%

Source: National Center for Charitable Statistics

larly hard, even as demand for their services soars. Paul Light, a professor of public service at New York University, has predicted that “at a minimum” more than 100,000 nonprofit organizations could be wiped out in the next two years.³ Indeed, even nonprofits with well diversified sources of funding are being squeezed from all sides: foundations are watching their endowments disappear and are limiting their grant making, states across the country are facing massive budget deficits, the demand for tax credits in the private sector has disappeared, and many individual donors are curtailing their giving as their own budgets tighten. In a survey conducted of 800 nonprofits at the end of 2008, 75 percent of nonprofits reported already feeling the effects of the downturn, with 52 percent already experiencing cuts in funding.⁴ Few nonprofits are adequately prepared to face an economic downturn of this magnitude: only 54 percent of respondents have three months or less of operating reserves and 74 percent have less than six months of operating reserves.⁵

Equally troubling is the relationship between funding stability and capacity, especially at the local level. Julian Wolpert, an emeritus professor at Princeton University, has long studied nonprofits and has identified that there is a high degree of unevenness and gaps in service provision within the nonprofit field. In particular, nonprofits and the infrastructure, funding, and support networks that help them to function are much weaker in low-income neighborhoods, and in neighborhoods that are experiencing rapid demographic and social change. A recent report released by the Federal Reserve Bank of San Francisco pointed out this dynamic in Fresno, which has the second highest rate of concentrated poverty in the country. As one community advocate pointed out, “Nonprofits here can’t compete with [San Francisco] Bay Area organizations on funding proposals—the writing is not as sophisti-

cated, and the applications aren’t as strong.”⁶ Nonprofits that are located in these areas also tend to be newer and smaller, and are therefore at a much greater risk of financial failure. So the regions with the least nonprofit capacity—and the highest need for services—are the ones that are the most likely to see nonprofits close under the strain of the recession.

Building the Financial Resiliency of the Nonprofit Sector

So how do we address these twin challenges of nonprofit funding and capacity? There is a growing literature on nonprofit finance that shows that funders of all stripes—banks, foundations, government agencies, and individuals—need to recognize the unique financial structure of nonprofits, and that building the financial resiliency of the nonprofit sector requires grants that support not only the nonprofit’s mission and programs, but also its capital structure.⁷

At a very fundamental level, nonprofits have a significantly different capital structure than for-profits, and many of the traditional finance rules do not apply. For example, in the for-profit world, the consumer is the one that pays for the good or service. In the nonprofit world, however, this is almost never the case—instead, a third party such as a foundation or government agency is often the one that pays for the service or product on behalf of the consumer.⁸ This often leads to a disconnect between the nonprofit and its mission: the nonprofit needs to satisfy the demands of both the funder and the consumer, and often the funder’s wishes comes first. This relationship creates a model of program delivery that runs contrary to a nonprofit’s strength: their close connection to the communities they serve. While a funder may think they “know” the answer to a problem such as homelessness, it is often



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the clients themselves who have a better understanding of what they need to get back on their feet. Moreover, a funder’s wishes may encourage mission creep, as the nonprofit applies for grants in new program areas just to sustain its existing operations.

Another factor that adds to the complexity of nonprofit finance is that the fee charged for the service or product rarely covers the cost. Efficiencies of scale and volume discounts that are the hallmark of companies such as Walmart do not apply in the nonprofit world. Gregory Ratliffe and Kirsten Moy provide a compelling parallel from the private sector: nonprofit finance is akin to a business that loses money on each widget it produces, and seeks to solve the problem by making more widgets. For nonprofits, which are effective precisely because of their high-touch products and services, a growth in clients is often accompanied by a growth in fixed costs.⁹ Instead, nonprofits are more likely to be able to expand their capacity when they make conscious long-term investments in partnerships with other institutions, infrastructure (e.g. standardized procedures; protocols and methodologies; industry-wide databases), and technology. As Ratliffe and Moy note, “Without the development of supporting infrastructure, replication and scale are not possible and promising demonstrations may be little more than isolated efforts.” Yet these investments require both capital and human resources, and are rarely the focus of funders who want to see how many clients were served for their dollars.

In fact, research suggests that the current trend that prompts nonprofits to be more business-like, demonstrate low overhead costs, and calculate the return on their investments may actually be undermining the effectiveness and sustainability of nonprofits. According to the Nonprofit Overhead Cost Study¹⁰, many nonprofits are sacrificing organizational infrastructure needs in order to tell funders the ratio they want to hear. Government grants generally specify the percentage that will be allowed for overhead (usually somewhere between zero and eight percent), and nonprofits that submit bids with the lowest overhead costs are often rewarded with additional contracts. Although this trend is driven by a desire to increase efficiency and ensure that public dollars are wisely spent, it has led to a “race to the bottom,” in which many nonprofits lack the

Fig. 2
Registered Nonprofit Organizations in the 12th District Filing Forms 990 in the Past Two Years, 2008

State	Total # of Registered Nonprofits	Total Assets Reported by Active Filers	Avg. Assets Reported by Active Filers
Alaska	5,090	\$7,573,774,042	\$1,845,708
Arizona	20,714	\$37,359,839,340	\$2,718,939
California	156,937	\$449,867,596,679	\$3,155,971
Hawaii	7,465	\$20,632,649,059	\$2,514,499
Idaho	7,510	\$9,978,482,231	\$1,579,516
Nevada	7,738	\$17,945,612,356	\$1,793,700
Oregon	21,944	\$59,004,038,437	\$3,932,841
Utah	8,712	\$13,850,883,503	\$2,469,212
Washington	35,092	\$155,303,236,685	\$3,375,894

Source: National Center for Charitable Statistics

infrastructure they need to be effective. Clara Miller, President of the Nonprofit Finance Fund, likens this trend to going to a restaurant and upon paying the bill, noting that you only want to pay for the talent of the chef who made the meal and not to the lighting, cooking supplies and silverware that are needed to keep the restaurant running.¹¹ This too may lead to perverse outcomes for the communities being served, since program delivery may shift to those interventions that are most responsive to the market test, as opposed to those most germane to the problems being addressed.

So what is the best way to support nonprofits and help build the capacity of the field? There is a growing consensus that there should be a greater emphasis on unrestricted grants, and that these should be the rule and not the exception.¹² Funders need to realize that they need to support the underlying ‘business’ that delivers the program, not just the program itself. In contrast, capacity-specific grants—such as a small grant for board development—are not effective without attention to the overall capital structure of the nonprofit. The Nonprofit Overhead Cost Project found that nonprofit weaknesses stem from systemic factors, such as the systematic under-funding of overhead, which can’t be addressed “by providing grants to one organization for board development and to another for computer purchases.”¹³ In fact, the study found that restricted funding is an important contributor to the capacity problem, which questions the wisdom of establishing restricted “capacity-building funds” to solve problems exacerbated by that very practice. As the authors of the study argue, if the systemic underinvestment in nonprofit overhead and infrastructure were addressed, the capac-

ity problem would also disappear. Having an adequate pool of unrestricted funds may in fact help a nonprofit better use restricted dollars, since the financial resiliency and support that comes with unrestricted dollars would translate into the ability to effectively use a pilot grant for a new program that expands the nonprofit’s activities. As Jon Pratt, Executive Director of the Minnesota Council of Nonprofits, has argued, paying attention to a nonprofit’s capital structure and making sure they have enough flexible funding allows nonprofits to “chart their own course and stay flexible, and have the time and freedom to ask the big questions and make long-term plans.”¹⁴

Still, this shift away from program restricted funding is uncomfortable for most donors, especially for those who are passionate about the nonprofit’s mission and want to make sure that their money is spent in a way that helps the most people. Unrestricted funding sounds as though a nonprofit could then spend it on whatever they want, be it service delivery or the staff holiday party. But “unrestricted” should not be viewed as synonymous with wastefulness or a lack of oversight. Funders can and should still be involved in program development and communicate with the staff about their plans for the funds, budget, and program strategy. Funders should continue to scrutinize the impact of their investments, but rather than focusing merely on whether or not the overhead ratio meets their expectations and the “outputs” of the number of clients served per dollar, the conversation should focus on whether or not the nonprofit has what it needs to be effective and whether the organization is effective at delivering better “outcomes” for the communities they serve. **CI**

Endnotes

Strength in Adversity: Community Capital Faces Up to the Economic Crisis

1. This article is a condensed excerpt of a Community Development Investment Center Working Paper, entitled "The Economic Crisis and Community Development Finance: An Industry Assessment." For the full article by Nancy Andrews, see <http://www.frbsf.org/publications/community/wpapers/2009/wp2009-05.pdf>
2. Among the eleven interviews, six were with national or large regional CDFIs; two were rural CDFIs; and three were small and locally targeted CDFIs. Two were in the Midwest, three were headquartered on the West Coast, and six were headquartered on the East Coast.

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2. Board of Governors of the Federal Reserve System, "Senior Loan Officer Opinion Survey on Bank Lending Practices, July 2009.
3. Board of Governors of the Federal Reserve System, "Financial Services Used by Small Businesses: Evidence from the 2003 Survey of Small Business Finance," October 2006.
4. Robert B. Avery, Raphael W. Bostic, Katherine A. Samolyk, "The Role of Personal Wealth in Small Business Finance," *Journal of Banking and Finance*, 1998.
5. Avery, Bostic, Samolyk, p. 1052.
6. Ibid, p. 1052
7. Ibid, p. 1059
8. Federal Reserve Bank of San Francisco, "Proceedings From the Impact of the Mortgage Crisis on Asian Small Businesses," July 1, 2008.
9. Ibid, p. 1045.

Strengthening the Low Income Housing Tax Credit Investment Market

1. This article appears in *Cascade* No. 72, Fall 2009, a publication of the Community Affairs Department of the Federal Reserve Bank of Philadelphia.
2. Source: National Council of State Housing Agencies
3. Ernst & Young, "Understanding the Dynamics IV: Housing Tax Credit Investment Performance," (2007), p. 49.

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1. John Bridgeland, Mary McNaught, Bruce Reed, and Marc Dunkelman (2009). *The Quiet Crisis: The Impact of the Economic Downturn on the Nonprofit Sector*. W.K. Kellogg Foundation.
2. David J. Erickson (2009). *The Housing Policy Revolution: Networks and Neighborhoods*. Washington, D.C.: The Urban Institute; Lester Salamon (1994). "The Rise of the Nonprofit Sector," *Foreign Affairs*, Jul/Aug, Vol. 73, Issue 4.
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4. John Bridgeland, Mary McNaught, Bruce Reed, and Marc Dunkelman (2009). *The Quiet Crisis: The Impact of the Economic Downturn on the Nonprofit Sector*. W.K. Kellogg Foundation.
5. Ibid.
6. Naomi Cytron (2009). "The Enduring Challenge of Concentrated Poverty in America: Case Study of Fresno, California," Federal Reserve Bank of San Francisco Community Development Working Paper 2009-04.

7. This article draws heavily from the special edition of *The Nonprofit Quarterly* entitled *Strange Accounts: Understanding Nonprofit Finance*, published in 2005.
8. Clara Miller (2005). "The Looking-Glass World of Nonprofit Money: Managing in For-Profits' Shadow Universe," *Strange Accounts: Understanding Nonprofit Finance*, Compiled articles from *The Nonprofit Quarterly*, pp. 5 – 14.
9. Gregory A. Ratliff and Kirsten S. Moy (2004). "New Pathways to Scale for Community Development Finance," The Federal Reserve Bank of Chicago, *Profitwise News and Views*, December 2004.
10. For more information on the Nonprofit Overhead Cost Study and its data and publications, visit <http://nccsdataweb.urban.org/FAQ/index.php?category=40>.
11. Clara Miller (2005). "The Looking-Glass World of Nonprofit Money: Managing in For-Profits' Shadow Universe," *Strange Accounts: Understanding Nonprofit Finance*, Compiled articles from *The Nonprofit Quarterly*, pp. 5 – 14.
12. Ibid.
13. Mark Hager, Patrick Rooney, Thomas Pollak and Kennard Wing (2005). "Paying for Not Paying for Overhead," *Foundation News and Commentary*, Vol. 46, No.3. Available online at <http://www.foundationnews.org/CME/article.cfm?ID=3313>.
14. Jon Pratt (2005). "Analyzing the Dynamics of Funding: Reliability and Autonomy," *Strange Accounts: Understanding Nonprofit Finance*, Compiled articles from *The Nonprofit Quarterly*, pp. 19 – 25.

Peer-to-Peer Lending and Community Development Finance

1. This article is a condensed version of the working paper entitled "Peer to Peer Lending and Community Development Finance." The full article can be downloaded from <http://www.frbsf.org/publications/community/wpapers/2009/wp2009-06.pdf>
2. Interview with Prosper CEO Chris Larsen on July 23, 2009. Source: Celent, a research and consulting firm focused on the application of information technology in the global financial services industry.
3. Laura Choi, "Creating a Marketplace: Information Exchange and the Secondary Market for Community Development Loans." Federal Reserve Bank of San Francisco's Working Paper Series: 2007-01. Available at <http://www.frbsf.org/publications/community/wpapers/2007/wp07-01.pdf>.
4. Nancy Andrews, "The Economic Crisis and Community Development Finance: An Industry Assessment," Federal Reserve Bank of San Francisco Working Paper Series, June 2009. Available at <http://www.frbsf.org/publications/community/wpapers/2009/wp2009-05.pdf>.
5. To date, only one platform, MicroPlace, has been granted approval from the Securities and Exchange Commission (SEC) to sell third-party-issued securities to multiple individual investors on its site without triggering a suitability requirement. While this is a key regulatory achievement, it is important to note that securities sold on MicroPlace are backed by their issuer—not the lender or the end borrower. The SEC has yet to allow any P2P finance platforms to sell third-party issued securities backed by assets (loans) online.
6. Low Income Investment Fund Frequently Asked Questions, available at <http://www.liifund.org/ABOUTLIIF/FAQ.htm#averageLoanSize>.
7. Interview with Chris Larsen on July 17, 2009.
8. Opportunity Finance Network's CARS website available at http://www.opportunityfinance.net/financing/finance_sub4.aspx?id=56.