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Nonprofit sector

Proctor: Is the nonprofit business model obsolete?

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Early in 2012, the nonprofit world was shocked by the bankruptcy filing of Hull House, a storied 123-year-old social services nonprofit. Blogs have been filled with finger pointing, suggesting that this event was avoidable. Maybe it was inevitable.

Peter Drucker wrote almost 20 years ago, "What underlies the current malaise of so many large and successful organizations is that their theory of the business no longer works. The assumptions on which the organization has been built and is being run no longer fit reality … Some theories … are so powerful that they last for a long time. Eventually, every theory … becomes obsolete and then invalid. When a theory shows the first signs of becoming obsolete, it is time to start rethinking the theory."

Hull House survived its first obsolescence, but it failed to recognize its second. The settlement house concept of Jane Addams was for prosperous people to work or volunteer in the city and live together in a house in a run-down, working class neighborhood. The great insight of the settlement movement was to create social ties between donors and recipients. This extended into very successful fundraising because donors were connected daily to the life of Hull House.

This approach evolved to having nonprofit employees doing most of a nonprofit's work, with donors connected abstractly and emotionally by reading and listening about a nonprofit's work. Hull House followed this change as well as the subsequent shift to providing services through contracts with government. As Louise Knight writes, Hull House reached a point where 85 percent of its revenue came from government contracts. When government cutbacks began over the past decade, Hull House tried without success to fill the gap through increased fundraising.

Over the past 25 years, the number of nonprofits grew threefold in the United States, and the nonprofit business model moved sharply toward being a contract provider of government services. Philanthropy filled the gap between what the government would pay and what it cost to provide the services. This worked fine in the 1990s and into the last decade. More nonprofits were created each year, more government services were contracted out to nonprofits, government payments persisted below nonprofits' costs, and contributions filled the gap.

But the assumptions of this business model no longer fit reality. The government has turned out to be an unreliable customer. It abruptly cancels contracts. It pays late. It continually holds payments down even while costs increase. Even the assumption that philanthropy is ready to fill the gap turns out never to have been a reality. Philanthropy had expanded in dollar terms as the number of nonprofits surged, but philanthropy in its best years managed to rise to only 23 percent of nonprofit revenue. Any notion that philanthropy would be able to be the primary revenue source was always a pipe dream.

The theory of business until now has been that a nonprofit could offer all of its services at less than cost and fundraise to make up the difference. I frequently heard people quip "nonprofits aren't supposed to make money." I still hear nonprofits tell me that they plan to solve their financial problems through fundraising.

Hull House couldn't replace lost government contracts with increased fundraising. It acted as though this was a temporary situation and in 2011 ran down its endowment, in the mistaken belief that it faced a seasonal shortfall that would be reversed soon. I don't believe Hull House realized that its theory of business had become obsolete.

I believe that the new reality is that the thousands of nonprofits that were created to provide services through government grants and contracts will no longer be viable. I also believe that corporate philanthropy has peaked and will steadily decline.

The future theory of nonprofit business needs to recognize the reality that earned revenue always has been the primary source of nonprofit revenue. The most recent data from the **Internal Revenue Service** show that earned revenue constitutes 77 percent of nonprofit revenue. This share varies by the type of nonprofit but it falls below a majority in only two sectors, education that is not higher ed and the arts, culture and humanities sector. The former still earned a significant 43 percent of its revenue and the latter a much smaller 29 percent. Even the human services sector raised more revenue through fees and contracts than it raised through contributions.

The assumption on which nonprofits have been operating the past few decades is that earned revenue can reliably be based on government contracts. This theory of business is obsolete. Earned revenue needs to remain the majority of nonprofit revenue, but it must come from non-government customers, and the government contracts that nonprofits do accept must come with terms that are closer to covering the true cost of services.

As Drucker wrote long ago, it is time to start rethinking the nonprofit business model.

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