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Strategic Choices in an Era of State Budget Cuts

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Abstract

An often overlooked reality in today's political discussions about the U.S. government's federal budget deficit and the overall debt—as well as individual state's budgetary shortfalls—is the effect potential remedies may have on nonprofit organizations. Because of a history of slowly giving in to government regulations and requests from bureaucrats, NPOs that provide contracted services on behalf of governmental agencies are already at a severe disadvantage: they are not only not covering their costs in these government contracts, but they are actually losing money—often having to go to private foundations or individuals to help cover the gaps in their budgets.

Nonprofits have brought this on themselves. Being so committed to delivery of services in order to achieve their missions, NPO leaders have cut back and sacrificed to the point of no longer being able to provide services. Indeed, many of the government contracts into which NPOs enter wouldn't even be considered by a for-profit enterprise: elimination of all profit margins, finding matching funds to pay for the services, and accepting late payments—sometimes 90 days late or more—without penalties.

In this piece, economist and nonprofit consultant Allen J. Proctor, Ph.D., discusses the implications that possible spending cuts and tax increases might have on NPOs, given their current financially lean circumstances. Relying on data from the Urban Institute, he presents three options for NPOs to consider as the political landscape becomes clearer in the coming months.

Keywords: human services, government contracts, spending cuts, federal budget, state budget, deficit, federal debt

A hard reality will soon be confronting the nonprofit world and those who believe deficit reduction will not affect them and their neighbors. Nonprofits have already felt the tight pinch from state budget cuts but they have responded in a way that has masked much of the impact from the public. As government deficit reduction continues, nonprofits will confront choices they have so far largely avoided: telling the government they cannot sign contracts on the punitive terms the government is offering. If the government persists, nonprofits will face a dilemma - denying some clients in order to continue services to others, or alternatively going out of business and thereby denying all clients.

This dilemma has been slowly building. State, federal and local governments have been talking about spending cuts for years. Sometimes they have cut, and sometimes they have not. Most taxpayers haven't noticed much impact on their lives.

They just see four words: debt, deficits, tax increases. This message is seductive, who wouldn't want to eliminate or avoid all of them? Eliminating debt is good for the country and it has no obvious personal impact. Eliminating deficits also sounds good for the country and is abstract enough for many individuals to anticipate no personal impact either. On the other hand, tax increases have an obvious personal impact and are claimed as unnecessary by many elected officials.

Why is this myth of spending cuts with no personal impact so popularly accepted and expansively broadcast by a wide swath of the political world? Much of the answer lies with the behavior of the nonprofit human services sector. By its devotion to helping serve community need no matter what, it has left many with the impression that government budget cuts have no meaningful personal impact. They have done this by being the buffer between government cutbacks and popular perception of public services.

The nonprofit sector is a major provider of government services. The Urban Institute recently surveyed human services nonprofits and connected with over 32,000 that have government contracts to provide governmental services.[*#] Three-fourths have multiple contracts with the government. This substantial role is one result of the outsourcing movement of the 1980s and 1990s, which sought to appease angry taxpayers by reducing highly visible government employment numbers through shifting service provision to the nonprofit sector.

In addition, the government has been solving its budget problems by out-Walmart-ing Walmart. Walmart is famous for

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Proctor has regularly developed innovative solutions to the financial and performance challenges of nonprofit organizations and for-profit corporations. Since establishing his company in 2001, Proctor has worked with clients to build a solid financial and strategic base for their future growth and presented workshops and seminars for audiences of all sizes.

Proctor has worked as a top executive at institutions as diverse as Harvard University (CFO and Vice President for Finance), New York City (Deputy Budget Director), New York State Financial Control Board (Executive Director), and Federal Reserve Bank of New York (Division Chief). Proctor earned his A.B. magna cum laude from Harvard University and his Ph.D. in economics and forecasting from the University of Wisconsin-Madison.

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pressing the profit margins of its suppliers. The government should be famous for **eliminating** the profit margins of nonprofits. It has done this in three ways documented by the Urban Institute survey. First, the survey found 68 percent of nonprofits were paid less than the full cost of contracted services. This was most prevalent in contracts with state and local government. Second, for over half of the nonprofits, the government reduced its payments even further by requiring its nonprofit contractors to match the government funding of the contract or to absorb a portion of the government's cost. Third, over half the nonprofits reported that the government pays even later than specified in the contract, typically 90 days later than contract terms.

These results mean that the majority of nonprofit service providers had to pay their bills when government payments weren't coming in and, when payments did arrive, the payments were less than the nonprofits' costs. This acquiescence has financially weakened nonprofit service providers.

The nonprofit sector has allowed itself to be taken advantage of in a manner that the for-profit sector would not tolerate for very long. First, a for-profit company would never sign a government contract that didn't cover its costs, and probably the company would insist on a profit. Second, a for-profit would add a significant interest penalty for late payments.

Nonprofits may also be encouraging the situation by penalizing themselves and their employees rather than exposing the public to any service impacts from the government cuts. Half of nonprofits in the Urban Institute survey have frozen or reduced staff salaries and over 40 percent have reduced staff benefits and drawn down reserves. But nationally only one-fifth made any reductions in services, and in 27 states the proportion of nonprofits who reduced services was even less than one-fifth. The upshot is that nonprofit cash and their employees' financial welfare have paid to maintain the government services and left many taxpayers with the impression that tax increases are not needed in order to preserve these services.

It would be a grave mistake to assume that philanthropy can solve this problem. Recent IRS Statistics of Income shows that philanthropy is only 22 percent of nonprofit revenues, and the share has not exceeded 24 percent since 1985. The only way the next wave of government budget cuts is going to occur with no impact on government services is if nonprofits have more savings to draw down or their employees can survive with even lower salaries and benefits. It is difficult to envision this continuing for very long.

In Ohio, where state and local budget cuts loom very large, the picture is even worse. In the Urban Institute survey, Ohio ranked eighth in the proportion of nonprofits receiving payments that are less than the cost of services, and it ranked 12th in the proportion receiving those payments late. Yet Ohio nonprofits tried harder than nonprofits in 28 states to avoid any service cuts. They were the 11th most likely to reduce or freeze salaries, the 8th most likely to reduce benefits, and the 13th most likely to reduce employees. But Ohio nonprofits don't have much flexibility left - they were the 40th most likely to draw on reserves and the 22nd most likely to borrow or draw on lines of credit. Most likely, they had no reserves left to draw upon and instead tapped lines of credit as much as they could.

Ohio's nonprofits have protected its citizens from the impact of government cuts better than nonprofits in most other states. They have cut staff salaries and benefits even after borrowing more often than nonprofits in most other states. Their ability to continue this response seems limited yet Ohio taxpayers have little idea of how much they have been protected from the consequences of state and local cuts.

This may have to end and taxpayers in Ohio and elsewhere may finally realize the myth of "don't raise my taxes but don't cut my services." When the next round of government cuts comes through, Ohio's nonprofits will find they can ask no more of their hard-pressed employees and their bank accounts will offer little help. Lower government payments will have to be reflected in fewer services.

What will the taxpayers say when the services disappear? It would be ironic if they blame the nonprofits for service cuts. But nonprofits have only three options, all of which point to eventual reduction in nonprofit provision of services.

Option 1: continue doing what they have been doing. If salaries or benefits go much lower many of their employees will have to seek work elsewhere. Losing employees, or alternatively laying them off, will have to result in reduced services. If they don't do either, they will operate until they can't make payroll or pay their bills. Going out of business is a guaranteed service reduction. Since the nonprofit will announce these outcomes, the taxpayer will likely blame them for inefficiency or poor management rather than blame the government's inadequate payments.

Option 2: play hardball and refuse to sign contracts that don't cover the full cost of providing services for the government. This is the nightmare of all nonprofits: "if we don't take the contract our competitors will." This is a no-win dilemma: survive by not taking government contracts and shift your clients to another "more caring" nonprofit, or take the contract and join the race to the bottom of Option 1. If a nonprofit opts for the first choice, the public will criticize it for not caring, and the government will likely blame service reductions on the refusal of nonprofits to "help" the government to provide services. If a nonprofit opts for the second choice, it will fail and the "inefficiency" of nonprofits will be blamed for cessation of client services.

Option 3: play hardball by joining together and demanding better contract terms from the government along with a clear public relations campaign that lays out the financial reality of nonprofit financial survival and puts the entire discussion into terms that businessmen understand: "pay less than the cost is a sure formula for bankruptcy – and nonprofits aren't loading a profit margin on top!" Nonprofits have never done this and they have little practice in working as organized groups. And some may see an analogy to unionization and refuse to collaborate, blaming the collaborators for trying to better themselves at the expense of larger government deficits and leaving their clients in the lurch.

None of these is a good option, and all have the potential for the nonprofits to take all the blame. Nevertheless, moving cautiously ahead on all three options may provide the best way for Americans to get realistic.

Nonprofits must make sure they know what their key mission service is versus the services which have alternative nonprofit providers. They must ensure that the key mission is the service they continue to provide even under money-losing contracts. They should concentrate their layoffs or wage reductions in the other service areas. This approach would be one step back from the brink of Option 1.

Every nonprofit should set a goal for the next year to reject at least one money-losing contract, however small, in the next six months. That is one step ahead under Option 2 and it may succeed in starting a more productive discussion of the essential role of the nonprofit sector in the supply chain of government services.

Finally, it is timely for nonprofits to form local associations. In Ohio I know of the Human Service Executives of Greater Cincinnati, the Franklin County Human Services Chamber, and the Columbus Cultural Leadership Consortium. I hope there are many more. They should be encouraged to share their financial challenges with each other and they are likely to learn they are all in the same boat. And they should be encouraged to create united messaging to their elected officials that describes how much they lose on their government contracts and the impracticality of expecting philanthropy to surge to fill the gap. Such actions will be one step ahead under Option 3.

Little steps on all fronts will draw some unsympathetic criticism. The alternative for many nonprofits, however, would ultimately be bankruptcy. In either case, the taxpayers may finally see that government deficit reduction means fewer of the services they believe is their right.

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