The Bridgespan Group

The View from the Cliff

Government-Funded Nonprofits Are Looking Out on Steep Cuts and an Uncertain Future

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The Great Recession has been difficult for almost all nonprofit organizations. For those that rely primarily on funding from foundations, individual donors, membership dues, or user fees, economic recovery is a light shining at the end of the tunnel. Their funding will pick up with the economy. For those nonprofits that depend on government funding–especially those organizations that deliver human services–there is a cliff at the end of the tunnel. Based on a recent Bridgespan Group survey, and interviews with nonprofits that depend on government funding and government leaders themselves, much of this revenue is poised to fall off amidst the public sector's ongoing fiscal shakeout.

This report will relay the results of our study, but first some background: Our national safety net of human services to feed the hungry, house the homeless, or mentor at-risk youth, etc., is a curious public-private hybrid. Federal, state, and local government underwrites the bulk of the cost of supporting vulnerable people in our society. But most services are delivered by nonprofits operating under government contracts or grants. In essence, government outsources its social work. The Urban Institute reports that "in 2009, governments contracted with human service nonprofits for over $100-billion worth of contracts and grants. For organizations with government contracts and grants, government funding amounts to 65 percent of total revenue."[1]

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Our society benefits from this hybrid approach. It allows government agencies to take advantage of the entrepreneurial spirit and local ties of the country's human service nonprofits, many of which have been serving their communities

[1] Boris, Elizabeth T. de Leon, Erwin, Roeger, Katie L., and Nikolava, Milena. *"Human Service Nonprofits and Government Collaboration: Findings from the 2010 National Survey of Nonprofit Government Contracting and Grants,"* Urban Institute, 2010, p. 5.

since the nineteenth century. And it is more cost-effective to deliver these services through community-based nonprofits than through public sector workforces. For their part, the nonprofits receiving government contracts and grants have more resources and can in turn have more impact.

This funding–and the safety net of essential services it supports–is under threat. The federal government is facing record budget deficits and interest payments to service its rapidly accumulating debt, the rising cost of health care, and the demographic challenge of paying for Social Security and Medicare for the baby boomers who are just starting to retire. Given that roughly a quarter of state government funding and a third of local government funding comes from Washington, DC, the federal budget squeeze in turn will impinge on human services budgets at those levels. For their part, state and local governments are grappling with the rising costs of health care in their own budgets and have an additional demographic time bomb to defuse in the form of $1 to $3 trillion (depending how you estimate it) in unfunded pension and other retirement benefit liabilities. As one former state government chief financial officer (CFO) told us, echoing a common view among the state and local officials we have talked with, "All levels of government are facing steeper costs on health care and pensions, where the relentless demographics are just grinding down on all other items in the budget."

The grinding down is about to accelerate in the wake of Budget Control Act of 2011 and the failure of the equally misnamed congressional super-committee that it created. The result: over $2 trillion in federal spending cuts over the next 10 years, roughly half of which will come out of domestic spending. While these cuts represent a small fraction of the deficit reduction that will eventually be required in the federal budget, they will have a big impact on state and local government budgets that have already been heavily strained by the recession–and the nonprofits that all three levels of government fund to deliver human services. As the former CFO we spoke went on to observe, "You are going to see a negative cascade as the federal cuts get pushed down to the states, and those in turn get pushed down to the cities and towns."

How are the nonprofits funded by these different levels of government seeing things as this cascading begins to unfold? What do they believe the future holds for them and the beneficiaries they serve, and how are they preparing for that future? How do their perspectives compare with those of the government leaders and agencies that retain and fund them to deliver services?

To help answer these questions, in late 2011 The Bridgespan Group surveyed 68 nonprofits that receive the majority of their funding from federal, state, and local government sources, then conducted in-depth interviews with a score of them. We also spoke with several public officials at the state and local level to get their perspectives from the other side of the contracting and grant-making table.[2] This report, based on those surveys and interviews, as well as on Bridgespan's ongoing client work with a wide range of nonprofits heavily dependent on government funding, provides a snapshot of this part of the social sector in very uncertain times.

The bottom line: Most of the nonprofits we spoke with have managed to survive the tough economic times with their government funding intact, floating in large part on a bubble created by federal stimulus funds. But the bubble is set to burst, and the cliff is just ahead. Nonprofits are deeply concerned about the coming government funding squeeze and appear to have only limited options available as they look ahead to tougher times.

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1. Despite considerable adversity, the majority of nonprofits we surveyed have thus far managed to survive the recession with their government funding intact.

Thirty-eight percent of respondents to our November 2011 survey reported a decrease in government funding since the recession began; 27 percent reported that their funding had stayed the same; and 35 percent that their funding had actually increased. Initially, this surprised us–how had so many weathered the downtown without reduced revenues from government?

Our conversations with nonprofit leaders indicated that while there have been considerable reductions in state and local funding in particular, some of the impact has been blunted by the ongoing execution of grants and contracts awarded before the downturn, and by the continued outsourcing of state and local functions to nonprofit agencies. In this regard, one nonprofit CFO noted that the state they operate in has relied more and more on organizations like his in recent years–not as collaborative partners, but as a lower cost way of providing services that have been done in-house by a higher cost public sector workforce. "If we can do it for 60 to 70 percent of what it costs them, they will turn to nonprofits to do it."

[2] We received survey responses from a diverse group of 68 nonprofit organizations that reported government revenues accounting for at least 50 percent of their budgets (out of a larger pool of organizations that were contacted). The organizations ranged widely in size, location, and program focus. The vast majority of our respondents provide human services of one form or another, but the sample also included a handful of organizations working in the areas of the environment, education, arts and culture, and international development. In addition, we conducted in-depth interviews with leaders from 17 of these organizations, as well as interviews with a half dozen current or former officials in state or local governments who are knowledgeable about nonprofit funding issues. To ensure candor, all interviews were conducted on an off-the-record basis.

For the nonprofits in our sample, reliant as they are on government money, federal funding has been a relatively bright spot–notwithstanding mandated low overhead rates that squeeze service delivery. Some of this has been due to new federal programs, such as initiatives to improve health care services driven by the Patient Protection and Affordable Care Act of 2010, or the greater focus by the Department of Veterans Affairs on reducing homelessness among veterans. Yet our interviews indicated that the biggest driver of the uptick in government funding experienced by some nonprofits over the last two to three years has been federal stimulus spending. The more than $700 billion put into the economy by the American Recovery and Reinvestment Act (ARRA) since 2009 has provided a huge infusion of dollars into a wide range of human service areas. But the great bulk of that funding, always intended to be short term, has now been spent. As the chief executive officer (CEO) of one large human services agency noted, "ARRA funding has been enormously helpful, but you get drunk on it, and then what do you do?" Another nonprofit leader characterized the stimulus money running out as "a cliff we are toppling over."

2. Leaders of government-funded nonprofits and state and local officials are bracing for forthcoming federal cuts on top of continued state and local shortfalls.

The steep drop of the funding cliff for government-funded nonprofits is the result of the stimulus running dry and the forthcoming cuts–not the last that are coming down, by any means–in baseline federal spending. Hence the ominous view from the top. Indeed, in this one matter the nonprofits leaders we surveyed were nearly unanimous: 91 percent agreed that federal cuts will "cause significant problems for our organization as we seek to fund our mission."

But beyond the generalized concern, there is considerable uncertainty. Only 55 percent of our survey respondents agreed that their organization "has an adequate understanding" of how the cuts will impact them. In interview after interview, leaders emphasized how little information they had about what kind of cuts might be coming over the next several years, or how their organizations might be effected as the federal cuts hit already stretched state and local budgets. Super-committees, sequestration, and the rest of the budgetary sound and fury from Washington feed the sense that the future is unpredictable. One East Coast nonprofit leader told us, "You don't know if they are going to cut, or if they do cut whether it will be reversed with the stroke of a pen." Many of these same nonprofit leaders have been living with this kind of uncertainty at the state level for several years now. As the CEO of a California nonprofit said, "We live in an ongoing structural [state] budget crisis that is compounded by the fact that our legislative parties can't compromise. This inability to compromise … is something California has been dealing with for the last three to four years, whereas the Feds are just now dealing with it."

Though almost all the organizations we surveyed receive some federal funding, most rely on a mix of federal, state, and local sources. These organizations tended to be pessimistic about their funding future–with almost two thirds expecting their funding from all government sources to shrink over the next two to three years. Though a third of their organizations had actually increased their government revenue recently, much of that due to stimulus funding, virtually none expected an increase in the years ahead. This pessimism is based in part on the news from Washington, but also the sense that some state and local budgets may still take years to recover from the economic shocks of the last few years, and that fiscal fundamentals–the ever-increasing cost of health care, the burden of oft-deferred funding in public pension systems –will put long-term downward pressure on available funding. Another source of pressure on funding flagged by state and local budget officials is the need for states to hit minimum maintenance-of-effort requirements to receive federal matching funds in programs like Medicaid, which in a time of tight funding will further reduce the portion of state budgets than can support a state's own human services priorities where those priorities do not overlap.

As to where these cuts will fall over the next several years, we heard a wide range of views. If there was any consensus, it was that the hardest hit will be programs serving the most vulnerable groups with the least political clout, e.g., people struggling to cope with mental illness and substance abuse, the victims of domestic violence, frail elders, and the homeless.

For their part, state and local budget officials are acutely aware of how the fiscal crunch is bearing down on the nonprofits they use to hold up the safety net. As one state human services director told us, "Our nonprofit agencies feel like they are hanging on by their fingernails. When they are putting together their budgets, they see a 3 percent cut here, a 6 percent cut there, a 10 percent cut here. They are having to rescale themselves." A budget official in another state observed that things are about to get worse as her human service department absorbs the pending federal reductions: "The budget cut we know is coming is really the elephant in the room right now. Many people don't even know it is there, and they won't until they get a letter from us saying that we have to cut back their contract."

A recurring theme in these conversations is how the fiscal shakeout we are in the midst of will have a far-reaching effect on nonprofits and the people they serve. One big city CFO observed that, "we are never going to recover those dollars, those old funding levels. A lot of those things governments and nonprofits have been doing to cover operating losses–at some point you are going to run out of corners to sweep out. So many people now are playing a short-term game, but it is not sustainable. You are going to see a shake out soon enough, with people having to make tough choices about serving fewer kids, or shutting down."

3. Nonprofits have been using multiple strategies to respond to the government funding situation–with some being much more sustainable than others.

For government-funded nonprofits, the Great Recession is driving what might be termed the great belt-tightening. Most organizations surveyed have taken at least some of the usual steps here–reduced staff, frozen salaries and hiring, and instituted a variety of administrative efficiencies. In interviews, many nonprofit leaders discussed how they have used interns or volunteers in the attempt to fill paid staff positions, or have simply sought to achieve the same results with fewer people. The CEO of a community mental health center reflected a common approach: "We cut staff holidays, reduce benefits, make people pay more for health insurance." But this CEO also noted the toll of such continual trimming. "We have people here because they are driven by the mission, but at a certain point this is no longer sustainable."

One of the basic problems with the belt-tightening approach is that it assumes at some point there can be belt-easing. As indicated above, that is not likely to be the case for government-funded nonprofits. And in many instances cinching the belt ever tighter will still fall short of the restructuring that will ultimately be required. For example one county official told us that the prior year she had to reduce a $1-million contract with a domestic violence shelter by 50 percent. This year the organization had come back with a proposal to restore funding to its prior level–all the while the administrator was worried she would not be able to maintain the shelter's funding at even the reduced level. As the former state government CFO we spoke with warned, "The real question nonprofit leaders should be asking themselves is, 'how can I adjust our operating model to get to a fundamentally new cost position?'"

The silver lining here is that many nonprofits are responding to the current environment in ways that could enable this kind of fundamental reset in their work. In a recent article in the *Stanford Social Innovation Review (SSIR)*[3], we outlined several ways that nonprofits have been rethinking their work in response to government funding challenges. Among the nonprofits

[3] Daniel Stid and Willa Seldon, "Five Ways to Navigate the Fiscal Crisis," *Stanford Social Innovation Review*, Winter 2012.

surveyed for this report, the great majority are already using at least a few of these approaches, including:

- *Getting to strategic clarity*: This involves articulating the impact organizations want to be held accountable for, specifying how they will go about realizing that impact, understanding the true cost to deliver each program, and making decisions about government contracts and grants in light of how they will affect both the organization's mission and its finances.

- *Diversifying funding streams*: Though the organizations we surveyed get most of their revenue from government, some are attempting to build up their complementary sources, such as individual giving or private insurance. For many, though, diversifying funding means seeking grants and contracts from a broader range of government agencies and program types, to guard against the potentially devastating impact of a large cut in, or the loss of, a single contract.

- *Measuring outcomes*: Too often outcomes measurement is something nonprofits feel obliged to do for reporting to external parties about their past performance. But the real power of measuring outcomes is to drive internal reflection and learning about how the work is going and planning how it can be improved. Viewed in this way, measurement can become a powerful way for leaders and staff to connect with and advance their organization's mission–something that is especially critical to do in adverse financial times. It also helps leaders make better tradeoffs in streamlining programs and–not least–can help secure funding for the ongoing work.

- *Improving productivity*: In this survey, and in our other research, we have seen signs that some high-performing human services providers are sharpening their focus on productivity, improving the way they manage their quality, costs, and processes such that they are truly able to do more with less–instead of having to just grin and bear it when government funders tell them they must do so.[4]

- *Engaging government funders as customers*: This is rarely a natural inclination for nonprofit organizations, which tend to see their downstream beneficiaries as their customers (if they think of anyone in those terms). The difficulty of working with government agencies in a fiscal crunch reinforces this orientation. However, nonprofits are the ones selling their services, and government agencies are the ones doing the buying (or not). High-performing nonprofits are distinguished by

[4] Alex Neuhoff and Robert Searle, "More Bang for the Buck," *Stanford Social Innovation Review*, Spring 2008.

their determination to understand the needs, challenges, and headaches their government funders are facing, and in developing compelling solutions to address them.

Another important strategy in the face of potential fiscal crisis is contingency planning. While less than a third of those we surveyed reported having in place a "complete detailed contingency plan for various government funding scenarios," another third report that they are planning to develop one. We would underscore the importance of taking this step based on our experience working with human services clients. It doesn't need to be comprehensive or overly detailed to begin with. For example, organizations can get a leg up by simply starting with up to 10 of the largest government grants or contracts, which in most organizations will account for a disproportionate amount of their revenue; thinking through the potential ways those funding streams could change; and identifying practical options for dealing with those possibilities.

These steps–very difficult, but not especially complicated–can help high-performing nonprofits cope with the fiscal crunch. But they will not resolve the deep-set problems borne of the fiscal crunch that currently face our hybrid system for funding and delivering human services in this country. For this we need more fundamental solutions.

4. Commonly-touted sector-wide solutions to the problem don't appear up to the task–and will be harder to realize in the ongoing fiscal crunch.

What are the options in this regard? In our interviews, we explored several kinds of responses that have been put forward by nonprofit leaders, advocates, and observers as potential sector-wide solutions to respond to the fiscal crisis, including advocacy to defend against cuts in social services, improved contracting by government agencies, and consolidation or collaboration across nonprofit organizations in the sector. There are sound arguments supporting each one of these responses. However, based on the input from our survey and interviews, as well as our experience working with clients, we don't see any one of them leading to the breakthroughs needed. Indeed, in important respects our fiscal problems will make them harder to do.

Advocacy to preserve and enhance funding: Some of the savviest government-funded nonprofits got where they are in part by knowing how to advocate for themselves and their programs. In the fiscal crunch, many are likely to rely even more on this tried-and-true strategy. And in the narrowest sense–keeping that agency and its programs alive–it might work. As a big city CFO told us, "I see a lot of capricious decisions that don't make sense, except for the fact that somebody knows somebody.

Nonprofit leaders need to be investing in that, even if it doesn't seem to relate to the work at hand." Many of the nonprofit leaders we interviewed spoke to us about just this kind of lobbying effort. But especially in tough fiscal times, such focused, narrow-bore advocacy (as opposed to broader movement building on behalf of beneficiaries and communities) is going to be a zero-sum game, helping one set of nonprofits or program category at the expense of another. As a state human services director told us, "Nonprofits' advocacy needs to be broadened to a larger systems view. Typically, nonprofits, their advocates, and their lobbyists will come to argue for a certain thing–child welfare, long-term care, etc." What they need to do, this official tells them, is to advocate for improved service-delivery systems across the board instead of only "focusing on what is happening in their silo."

Improved government contracting: Many sector advocates have argued that better government contracting practices would allow nonprofits to have more impact with limited resources. The current practices are clearly broken. Among responses to the 2010 Urban Institute survey of human service nonprofits, for example, 68 percent said the failure for government to reimburse them for the cost of delivering services was a problem, 53 percent said late payments by government agencies were a problem, and 57 percent said that unilateral government changes to existing contracts and grants were a problem.[5] We heard many complaints about government contracting practices among the nonprofit leaders we talked to–some of which were phrased in ways that cannot be repeated here!–but little expectation that these practices would change, except perhaps for the worse. In the face of the coming shortfalls, government is going to be even more inclined to use its dominant market power to squeeze its nonprofit contractors than to improve the contracting relationship.

Consolidating and / or collaborating across nonprofits: A shake-out, with many smaller or weaker players merging with larger ones, or simply closing their doors, has been one of the most widely predicted results of the sector's budgetary woes, and one that many funders and observers have advocated for. And while such a large-scale thinning of the ranks of government-funded nonprofits could be in the offing, our research suggested it is still a ways off. Barely 10 percent of our survey respondents indicated they have found mergers or acquisitions to be an effective means of coping with the funding situation. Indeed, in the depths of the Great Recession, our polls found 20 percent of nonprofits considering mergers, but not more. Many dynamics stand in the way of willful consolidation, even in the face of extreme financial pressure. We continue to be struck by what the leaders and boards of the smaller organization stand to lose through consolidation, and what little–apart from the sustainability of their mission

[5] Boris et al., "Human Service Nonprofits and Government Collaboration," p. 13.

in a different context–they have to gain. The head of a community mental health center discussed the reluctance to consider mergers, even among the smallest organizations in his field. “They just want to preserve their own little fiefdoms. You want them to say that ‘If someone else could come in and do the same thing more cheaply, I will turn over the keys.’ But that is not the typical nonprofit leader mindset.”

If a wave of consolidation is not likely to break anytime soon, what about increased collaboration that doesn’t formally combine previously separate organizations? More than half of the survey respondents indicated that they were collaborating on programs with other organizations. One of interviewees summed up his advice for other nonprofit leaders in three words: “partner with everybody.” This could be a promising development inasmuch as it has different nonprofits working together more, with each contributing what they are really good at in solving social problems instead of trying to do everything themselves. But as we spoke with nonprofit leaders, those attempting to collaborate more often had hazy and different understandings of what collaboration entailed. The most prominent recurring theme here was teaming with other organizations to get or keep access to funding that would not otherwise have been available. There were precious few examples of collaboration that was taking costs out of the system; indeed, we talked with some larger nonprofits that had actually sought to offer the systems and infrastructure they had invested in to smaller nonprofits who were struggling to develop their own, only to find that the smaller organizations in their field were not willing to avail themselves of the offered economies of scale because, as one frustrated CFO put it, they were “worried about us gobbling them up.”

5. Our interviews pointed to two sector-level solutions to the fiscal shakeout that hold some practical promise, but they also face barriers.

In conducting the research for this report, we heard no clarion call to action. But we believe there are important paths to explore. Some of the leaders we talked to were thinking about two potential opportunities for responding to government funding shortfalls related to using better human services to reduce health care costs, and more broadly focusing resources on programs and providers that demonstrate superior results. Both paths require nonprofits and their funders to surmount the hump of investing in prevention to lower the longer term cost of cures. In some cases, however, returns can accrue in the short term.

Using improved human services to reduce health care costs: We have used the phrase “funding cuts” often enough in this report. But if we consider health and human services budgets as a whole, government funding may be headed up, not down. Last month for example the National Association of State Budget Officers noted that, in aggregate across states, Medicaid–the largest single component of state budgets–has grown from 21.9 percent in 2009 to 23.6 percent in 2011. By comparison, education, the second largest component, fell from 21.5 percent to 20.1 percent over that same period.[6]

But what if certain kinds of human services spending–tied to evidence-based strategies in public health–could not only improve the health and well being of some of society's most vulnerable individuals and communities, but help control health costs as well? A state health and human service administrator we spoke with reported that in her department 11 percent of the people served accounted for 43 percent of its expenditures. "You can't buy smarter and assume you will affect the cost curve with these dynamics," she notes. "It is the case management function that is most important." A robust and sustained effort to identify and support the 11 percent via carefully targeted and highly effective human services could significantly reduce the 43 percent of primarily health care driven-costs. There is increasing evidence, if not quite a consensus, that some large cost drivers–e.g., poorly controlled asthma among children, falls among the elderly, repeated use of emergency and hospital services by chronically homeless individuals, and others–can be significantly curtailed by well-designed non-medical strategies focused on individuals and families at risk that address housing conditions, social support, and other "social determinants" of health.

To be clear, this approach requires breaking through hardened bureaucratic silos in government and indeed rethinking basic notions of health care, where and how it should be provided, and indeed who provides it. Rather than a white-jacketed physician seeing conventionally-insured patients that come seeking treatment in his office, it might be a social worker visiting a public housing apartment to help a single-mother of a young family manage both her depression and adult-onset diabetes. While this would be a major shift in approach, in light of current trends, governors and state legislators struggling to balance their budgets in the face of ongoing federal cuts may soon find that they can't afford to not invest more in these upstream, lower-cost solutions.[7] They will need to have high-performing human service nonprofits to retain in realizing the dividends from these budget shifts.

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[6] National Association of State Budget Officers, "NASBO State Expenditure Report," December 2011.

[7] For more on this approach and the opportunity, see Atul Gawande, "The Hot Spotters," *The New Yorker*, January 17, 2011, pp. 41-51 and Elizabeth H. Bradley and Lauren Taylor, "To Fix Health Care, Help the Poor," The New York Times, December 9, 2011, p. A39.

Focusing resources on programs and providers that demonstrate superior results: There are several ways that government can reduce expenditures on human services to bring them within available means. One approach is to zero out what are judged to be the lower impact programs and fully fund the higher impact ones.[8] But far more common, in our experience and others', is the proverbial "haircut"–all the currently funded programs continue to get funded, they just get less. Such an across-the-board approach may appear "fair"; moreover, it minimizes the political fallout of singling out particular programs for cuts. But as this year's cuts are piled upon last year's, a starvation process sets in. As one state budget director lamented, "After many budget reductions, you end up doing everything worse, rather than doing some things very well."

The same logic holds true for prioritizing and making tradeoffs in funding across nonprofit providers of a particular program. As one urban CFO explained, "It's hard to be the bad guy and say 'we had 10 grantees and now we are going to only have eight.' It is comparatively easier to say 'we had 10, will continue to have 10, but we need to give everyone a haircut.' It is made more difficult by the fact that these are venerable institutions that have a powerful legacy whose leaders and board can wield considerable political influence."

Political influence, and a natural desire by everyone involved to protect their piece of the pie, will always be with us. But as the pie shrinks, we hold out the hope that a broader constituency for what works can be mobilized to support government decision makers in concentrating our increasingly scarce public resources on those programs and providers that provide society the most bang for the buck. Instead of "doing everything worse," even in tough times–especially in tough times–perhaps we can still summon the political will and pragmatism needed to do some of society's most important work very well.

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[8] These are imperfect judgments, but it is increasingly possible to ground them in solid research – see for example www.coalition4evidence.org and the Washington State Institute for Public Policy, "Return on Investment: Evidence-Based Options to Improve Statewide Outcomes," July 2011.