Service Contracting with Nonprofit and For-Profit Providers:

On Preserving a Mixed Organizational Ecology

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This is the ninth paper in a series dedicated to understanding innovation in public public sector. The Ford Foundation launched the Innovations in American Government Program in 1985 and funded all of its elements through 2000. In 2001, the Foundation established an endowment at Harvard University to continue the Program in perpetuity and to locate it in a new Institute for Government Innovation. Each year, the Program selects the winners of the Innovations Award from approximately 1500 applications and supports research and casewriting based on the applicants. The Innovations in American Government Program also works in partnership with the Council for Excellence in Government.

Seeking greater programmatic effectiveness and lower costs, government agencies have long contracted with both nonprofit and for-profit providers for the delivery of a broad range of human services.1 In recent years, however, the stakes involved in many service contracting decisions have changed. Today, public managers are increasingly having to make judgments about the current and future structure of the provider marketplace that will have far reaching implications for the organizations that deliver services, the clients that rely on these services, and the public that ultimately finances them. In many fields of human service delivery, the delicate population ecology of nonprofit and forprofit service providers is profoundly shaped by government contracting decisions because public funding represents a large and critical source of agency finance.2 Thus, when public managers make decisions about the kind of organizations with which they will contract - nonprofit or for-profit - they simultaneously make choices not just about ways to achieve a particular policy objective, but also about the nature and composition of the population of service providers that will emerge at the end of the process.

The ecology of nonprofit and for-profit service providers has proven over time to be far from stable. Business activity has expanded in many fields long dominated by nonprofit organizations.3 For example, in the social services, large for-profit corporations are now providing job training, child care, and rehabilitation services at ever greater levels. In health care, forprofit hospitals and health maintenance organizations (HMOs) are buying out nonprofit institutions and moving into new markets. In education, publicly-traded firms have actively staked out a significant portion of the expanding charter school market in states from Arizona to Florida. In welfare-to-work services, several large defense contractors have begun to compete for and win contracts. As these and many other sectoral boundary incursions have occurred, and as for-profit providers have gained ground, nonprofit advocates have argued that it is now necessary to counter some of the real advantages that business firms possess in order to allow both nonprofit and for-profit providers to take part

in the delivery of complex human services. All of which raises the difficult question of how to preserve a human service marketplace that includes both nonprofit and for-profit organizations.

Sorting out -- through the allocation of government contracts -- the division of labor between nonprofit and for-profit service providers ultimately requires an appreciation of the advantages and limitations of for-profit and nonprofit organizational forms and the careful balancing of competing values and priorities across a vast range of contexts.4 In principle at least, some important public services may be better delegated to for-profit than to nonprofit organizations. Equally true is the proposition that other services may well be handled best by nonprofit organizations. The central argument of this chapter is that preserving room for both nonprofit and for-profit service providers across a range of fields, at least for now, must be viewed as a managerial imperative given the generally poor state of current knowledge about when and where one kind of provider or the other is most likely to serve the public interest best. While significant differences in capacity and culture may allow business firms to beat out nonprofits for service contracts, especially in situations where cost is a central concern, service contracting inevitably involves complex decisions about competing priorities that go well beyond the bottom line. The potential short term gains generated by exclusive for-profit provision may not always be large enough to justify the wholesale - and potentially irreversible - shifts in the long-term organizational ecology of human service fields that may be fueled by government service contracting that prioritizes one kind of provider over another.

The discussion proceeds in three major steps. In a first section, differences in the operational and cultural characteristics of forprofit and nonprofit organizations are detailed with an eye to highlighting why many believe business firms have certain important advantages over nonprofits when it comes to competing for large human service contracts. The second section explores why public managers may need to structure service contracts in a way that not only maximizes short-term results, but that also

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affirms the importance of preserving a mixed organizational ecology, especially until a more reliable knowledge base is built that can tell managers when and where to use nonprofit and forprofit providers. In a third and concluding section, some thoughts are offered on policy remedies that might supplement a more nuanced managerial approach to service contracting with nonprofit and for-profit providers.

I. Nonprofit and For-Profit Service Provision

As nonprofit managers survey the terrain of service contracting, many believe that the rise of for-profit human service providers poses major strategic challenges and questions, not least of which is how to hold on to the nonprofit sector's traditionally large market share and client base. Some nonprofit organizations have viewed the entry of business firms as a major threat and have attempted to respond to the new competition by becoming more businesslike in their own operations. This has sometimes led to the unreflective adoption of management tools such as total quality management, benchmarking, re-engineering, and other techniques that promise to improve operations.⁵ Other nonprofits have fallen back on the values and commitments that make the character and quality of their services unique. As a consequence, some nonprofits emphasize the commitment of their staffs, the underlying values or faith guiding the organization, and the unique community connections that many small organizations possess.⁶ While these emphases may help some nonprofits manage their service delivery operations better in the short run, they are unlikely to be enough to stop the trend toward greater levels of forprofit service provision and the erosion of many nonprofits' position in the contracting regime.

In key areas, nonprofits appear to face substantial structural obstacles to competing successfully with business in the market for government contracts. Data on the relative growth of nonprofit and for-profit provision of human services suggest that business may be capitalizing on its advantages to capture a greater share of human service markets that nonprofits have traditionally

dominated. The data indicate that the number of for-profit providers of individual and family services, job training and vocational rehabilitation, child day care, and residential care increased by 202% between 1977 and 1997, far faster than the number of nonprofit providers increased. During the same period, employment in for-profit human service providers increased by 273%, more than twice the growth rate within nonprofit establishments. Even the receipts of for-profit providers have increased at a faster pace than those of nonprofits. While nonprofits still managed to capture a substantial portion of the overall growth in the fields, the success of for-profit activity has raised the question of whether the division of labor between the sectors is beginning to undergo a reordering (See Table 1).⁷

When the competition between sectors comes down to the cost, speed, and quantity of otherwise similar services, nonprofit human services providers face at least five serious competitive disadvantages compared to business firms. Public managers seeking to manage the ecology of service providers must recognize that some of the disadvantages detailed below lend themselves to government action, while others clearly do not. The main task facing public sector service contractors in the years ahead is to fashion a response that is sensitive to the need to preserve the mixed organizational ecology that now characterizes most human service fields.

Scale and Complexity Limitations

One of the most common concerns of nonprofit service providers centers on scale limitations inherent in nonprofit enterprise. The financial and human resources of most nonprofit organizations limit their ability to mount complex, large-scale programs as quickly and easily as for-profit firms. Aside from a few highly visible national charities, nonprofit organizations are for the most part poorly financed and under-staffed. In fact, they often are run on extremely tight budgets with narrow fund balances carrying them from year to year. In addition, small nonprofits, which

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Nonprofit and For-Profit Social Service Provision: 1977 and 1997

(Includes Individual and Family Services, Job Training and Vocational Rehabilitation, Child Day Care, and Residential Care)

(Table 1)

	Number of Establishments		
	1977	1997	Change
Nonprofit Social Service Providers	40,983	92,156	125%
For-Profit Social Service Providers	23,104	69,713	202%
	Employment		
	1977	1997	Change
Nonprofit Social Service Providers	676,473	1,586,186	134.5%
For-Profit Social Service Providers	177,449	662,201	273.2%
	Receipts (\$1,000,000)		
	1977	1997	Change
Nonprofit Social Service Providers	\$9,415	\$75,683	704%
For-Profit Social Service Providers	\$2,038	\$18,894	827%

Source: Census of Service Industries 1977 and 1997. Data for receipts not inflation adjusted.

makeup much of the organizational population, lack experience with complex information technology and management systems, skills that are needed if they are to handle large caseloads and complex administrative requirements.

The size problem confronting many nonprofits puts business firms in a strong position within the emerging human services

contracts is simply enormous and requires a mastery of complex information technology. A grassroots or informal nonprofit organization that historically has focused entirely on delivering quality services to a small community seems almost certain to flounder under some of the substantial management demands placed on organizations seeking large public contracts. While some nonprofits may seek to create opportunities for themselves by pursuing, at lower levels of government, smaller contracts that include only direct client services and leave information-intensive reporting work to for-profit firms, coordinating such a division of labor over the long term will have substantial costs. In terms of sheer scale, many nonprofit organizations simply lack the operational capacity to tackle large scale contracts, including many of those recently put out for bid by the states under welfare reform.

Availability of Capital

Simple undercapitalization can be a serious problem for nonprofit organizations, given that some government contracts often withhold part of the service fees until the client has been served or some documented outcome has been achieved.¹⁰ In the rehabilitation services field, for example, a growing number of contracts only pay providers small up-front fees for each client served, with the balance of the payment delivered only after the client has completed their rehabilitation.¹¹ If a contractor only receives payment months after assisting a client, it must find a way to pay the up-front costs of delivering services while it waits for payment to arrive. Moreover, many contracts require facilities that the service provider must either be capable of acquiring or already have in their possession. This can put substantial capital demands on nonprofit organizations.¹²

The positions of nonprofits and business firms in raising the funds needed to meet capital expenses could not be more different. Business has long been able to raise millions of dollars through a range of financial transactions. By contrast, most nonprofit officials concede that their firms are undercapitalized by charitable

supporters and few have large revenue-generating operations to support major capital outlays. Moreover, even if nonprofit managers could raise operating capital through loans or other means, watchdog groups might well criticize these charities and accuse them of assuming too much risk and exposing their organization to financial stress.¹³

Business firms have several tools at their disposal to raise capital. If they are just starting out, they may approach venture capital investors and seek large amounts of funding and a long-term commitment in exchange for a stake in the firm. Often, this funding comes with the added bonus of an in-depth relationship in which investors lend management assistance to the firms in which they have a stake. Once a business firm reaches a certain level of operation, it has a second opportunity to raise capital in the equity markets. Through initial public offerings (IPOs) and routine stock offerings, business firms can command resources on a very substantial scale. With both venture capital and equities, business sells ownership stakes to outside parties. When businesses do not want to relinquish ownership, they can raise funds through the bond market. These funds must be repaid over time, but firms receive the benefit of being able to spread out major capital and research expenses over long periods of time.

Nonprofit organizations are in a distinctly different position from business firms in that they cannot sell ownership stakes. Because they are ownerless organizations, 14 nonprofits are not in a position to take part in equity markets. However, they can, and to a limited extent already do, use bonds to fund major capital projects. To date, most bond offerings have been confined to major institutions like hospitals, universities, and museums. 15 Few mid-sized nonprofits have been able to take part in the bond market and use these instruments to launch major expansion efforts. One reason bonds have not been a very popular instrument of finance lies in the high transaction costs associated with evaluating, underwriting, and servicing them. In addition, few existing banks are willing to invest the effort to establish lending criteria in areas where little track record is present. As a consequence, only the

largest nonprofits are able to meet the threshold at which a bond offering represents a viable option. Since many underwriters look not just at real estate in making decisions but also at reliable sources of income, nonprofits face a real challenge in convincing the lending community that their multiple revenue streams are reliable enough and their assets valuable enough to justify major financial commitments.¹⁶

Access to Power

Another potential trouble point for nonprofits is that business firms are able to lobby while public-serving nonprofits are somewhat limited in their ability to engage in such activity. Significant differences in style are obvious between the sectors, in terms of the political messages that are conveyed. Lobbyists for businesses often try to educate and inform government officials about the advantages of outsourcing and permitting for-profit competition in the human services. There have even been cases where business firms have intervened in the design of the contracting systems under which their firms would eventually operate. One reason for this comfortable relationship is that business is able to present a message of efficiency to government, while nonprofits often convey a message of equity and caring. Armed with political connections reinforced through campaign contributions and the potent claim of a strict bottom line, the capacity of business to shape the political and funding environment is more formidable than that of 501(c)3 nonprofits, which face real limits on lobbying and political activity.17

Limits on the political activities of nonprofit service providers were clarified by Congress in 1976, though it took the IRS fourteen years to issue final regulations. Nonprofits that elect to come under the law agree to certain limits on the expenditure of money to influence legislation. The regulations differentiate between direct lobbying, which aims to shape legislation through communication with legislators, and grassroots lobbying, which is targeted at shaping public opinion. The 1976 law established ceilings on total lobbying expenditures, ranging from 20 percent of

exempt-purposes expenditures for smaller organizations to a flat \$1 million for organizations with budgets over \$17 million. One of the most widely acknowledged flaws in the current rules of government lobbying by public charities is that the rules simply are not understood by nonprofit managers. Their reaction to the confusion over how much lobbying activity is allowed before the 501(c)3 status of a nonprofit becomes threatened has often been to avoid lobbying entirely or to conduct it under the umbrella of a 501(c)4 social welfare or advocacy organization that does not offer contributors a tax-deduction and which faces no limits on political activities.

Compensation and Human Resources

An additional problem nonprofits must confront is that major corporations have been able to gain a competitive advantage by attracting and hiring - sometimes with very lucrative offers prominent and well-respected human service officials from both the public and nonprofit sectors for management positions in their growing for-profit human service divisions. High-profile expertise is more likely to go to for-profit human services providers for the obvious reason that an undercapitalized nonprofit can rarely offer a salary comparable to what large corporations can pay. As long as business can attract the best talent, as they have recently in the job training and welfare-to-work fields, 19 nonprofit organizations are likely to face tough questions about whether they have the knowledge and experience to compete at the highest levels. Over time, if disparities between the sectors become too great, nonprofit organizations may face a real talent drain that will weaken the sector's competitive position.

For years, government largely turned a blind eye to the difficult issues raised by compensation levels within the nonprofit sector. However, the Internal Revenue Service has recently set in place a new regulatory framework to guide compensation in public charities and a system of sanctions that government can now impose on organizations that fail to comply. Government has taken a position on the subject of how much nonprofit managers

earn and has attempted to regulate compensation levels in the sector for a number of reasons: existing disclosure mechanisms are thought to be flawed and unreliable; nonprofit boards have weak incentives to monitor; several categories of nonprofits are substantially insulated from any market test; and, even if stakeholders monitor diligently, compensation regulation may be necessary to ensure that charitable dollars are dedicated to public purposes. New regulations were finally enacted as part of the Taxpayer Bill of Rights in July 1996. In August of 1998, the IRS released the details of its plan, and after receiving public comments, revised these regulations.²⁰ Rather than setting meaningful limits on nonprofit compensation as was intended, the regulations are likely to have the exact opposite effect and allow nonprofits to pay higher and higher salaries.

The new regulations define compensation as excessive if it "exceeds what is reasonable under all the circumstances." Compensation is reasonable "if it is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances." On the surface, this sounds like a fairly loose and porous standard, given the challenge to interpret the words "like enterprise" and "like circumstances." Because there is little case law in this area, the reasonable compensation definition by itself would leave organizations with little notice as to what was required of them and offer little protection to their expert judgment. In order to allow nonprofits to exercise this judgment with greater certainty, Congress placed a "rebuttable presumption" in the legislative history, and the IRS adopted it in the regulations. Charities may rely on a rebuttable presumption that their compensation decision was reasonable if it was approved by a board that: (1) is made up entirely of individuals unrelated to, and not subject to, the control of the disqualified person; (2) obtains and relies on appropriate comparability of compensation data; and (3) adequately documents the basis for its salary decision. Relevant data for demonstrating reasonableness include, among other things, compensation levels paid by similarly situated nonprofit and for-profit organizations for positions that are functionally comparable.

While these new rules are not well understood by nonprofit organizations, over time as the idea of constructing a rebuttable presumption using data on compensation at other nonprofit and for-profit firms takes hold, the lid will effectively be removed on nonprofit compensation. The intermediate sanctions regulations were initially designed to give government an alternative to simply closing down nonprofit organizations that engaged in financial mismanagement. However, the protections built into the system effectively make it possible for nonprofits to pay their executives the same amounts as similar workers in the corporate sector earn. Of course, it remains to be seen whether nonprofits will have the resources to do this, and the extent to which their boards and donors will go along with such an approach.

Normative Constraints

The last and, in many ways, most important obstacle that nonprofits face when attempting to compete is their lack of a profit motive and willingness to cut corners when the bottom line so dictates. When for-profit firms sign performance contracts that, for example, require specified reductions in the size of the welfare caseload, or pay a fee whenever a client is successfully rehabilitated, some observers worry about the consequences of these payment systems. One danger is that business firms will "cream" or "cherry pick" clients by focusing their attention on working with the most job-ready or least disabled clients, while writing off those with multiple barriers. For-profit firms may be tempted to reduce caseloads by cutting off eligible recipients or by taking other steps to achieve performance standards without helping clients become better prepared to function.

The trend toward outcome funding and performance pay raises all kinds of challenges for nonprofits that want to provide services but that have strong social missions and commitments.²¹ Over time, increased competition with business firms for performance-based contracts will likely strain the identity of nonprofit agencies or lead to the slow erosion of funding. Faced with a decision whether to compete or capitulate, many nonprofits

may reexamine their service delivery systems and look for ways to increase efficiency and effectiveness. While this work may lead to improved nonprofit operations, it also risks cutting into the "low return" charity work that nonprofit service organizations have traditionally undertaken. Special needs clients, particularly in the education, health, and social service fields, may find changes in the quality and availability of their often higher cost services as cross-sector competition and outcome-based funding take root.

It is not clear that it would be wise to do anything to tamper with cultural and ethical constraints that are part of the nonprofit sector's identity. While nonprofits – particularly those that are value and faith-based – may face real disadvantages when it comes to competing with for-profits in a market where outcome funding emphasizes quick and frequent case closures, there are many arenas where the focus of nonprofits on human needs and long-term personal development is integral to program success. In many nonprofits, the willingness to bend rules, make decisions that are related to mission not margin, and the dedication of staff allow these organizations to offer unique services.

Growing competition between nonprofits and businesses is significant because it ultimately risks narrowing the scope and vision of nonprofit organizations. As they become locked into increasingly fierce competitive struggles with businesses, nonprofit organizations risk becoming ever more instrumental in their approach. When nonprofit organizations are simply efficient intermediaries through which services are produced – efficient enough so that differences in methods between the nonprofit sector and business become obscured – questions naturally arise about why these organizations should be granted tax exemption. The competitive drive in some parts of the nonprofit sector to produce services at low costs is an important challenge to the sector's traditional charitable orientation.

II. Conceptual Needs for Service Contracting Across Sectors

The differences between the for-profit and nonprofit forms of organization suggest that as government continues to shift a

substantial portion of the responsibility for service delivery to providers outside of government, the ecology of for-profit and nonprofit organizations is likely to continue to shift over the coming decades, especially if business is able to capture the most lucrative and large-scale contracts that federal, state, and local governments make available. As a consequence, interpreting and reacting appropriately to the changing dynamics of the service contracting landscape is likely to be a central challenge for governance. Given the importance of public funds in most human service fields, it is increasingly hard to avoid the conclusion that as public managers make difficult decisions about what criteria to use in making contracting decisions, they will simultaneously be making decisions about the landscape of providers that is likely to emerge at the end of the process. What considerations should public managers therefore have in mind as they make these critical service contracting decisions? The answer given here is that traditional, short-term considerations must be expanded to include an appreciation of the effects these decisions have on the longterm evolution of the ecology of service providers in the many fields of human services where government funding represents a critical source of agency finance.

At first blush, it might be tempting to deny that the issue of contracting needs to be complicated at all. Some might view the trend toward greater levels of for-profit provision as a sign that business firms not only enjoy competitive advantages over nonprofits, but that they also offer better services. Additionally, one might conclude by looking at the growth of for-profit activity that clients simply find corporate forms of human service delivery superior to traditional nonprofit forms of assistance. These conclusions would be misplaced, however. While there is a fair amount of evidence supporting the fact that business firms have a competitive edge over nonprofits, there is almost no evidence that the services they render are of higher quality than those offered by nonprofit organizations. Indeed, evaluation research on the comparative performance of agencies across sectors is slim and contradictory.

Differences between nonprofit and for-profit forms of production have been analyzed in a select number of fields to determine if substantial differences in service quality and cost can be located. Beyond some basic intuitions, the actual evidence is utterly conflicted and inconclusive.²² Some studies have shown that nonprofit child care is of higher quality than for-profit alternatives. Other studies have shown high levels of parental satisfaction with for-profit providers. Some studies have detected differences in the levels of uncompensated care in nonprofit compared to for-profit hospitals, while others have not. Several studies have differed in whether greater efficiency is exhibited in for-profit compared to nonprofit hospitals.23 Early evidence on the comparative performance of nonprofit and for-profit charter schools is not yet conclusive, though parent interest in and satisfaction with some for-profit schools appears strong. In job training, government satisfaction with for-profit providers has been sufficiently high to drive substantial growth in this field, while, at the same time, raising concerns in some areas about the long-term effectiveness of these programs.24

Given this confused trickle of evidence, the current capacity of public managers to speak authoritatively about the desired organizational ecology of different human services fields is thus minimal. As a consequence, the shifting presence of for-profit and nonprofit providers can hardly be interpreted in many fields as the result of careful planning or strategy. And, the effects of some of the unplanned and unanticipated shifts have not always been positive. Anecdotal evidence suggests that there may be a fair amount of concern about the expansion of for-profit human services. In the area of health insurance, there is a growing chorus of criticism about the effects of for-profit health maintenance on the quality and accessibility of health services, a trend that has fueled calls for a bill of rights to protect patients. In the nursing home field, which has come to be dominated by for-profit firms, grave doubts have emerged about the capacity of the system to care compassionately for the coming tidal wave of elderly that the retirement of the baby boom generation will yield. Similar concerns have emerged in the area of welfare-to-work services,

where large corporations have established a significant presence. As corporations like Lockheed and EDS have secured large state contracts, many community activists have questioned the degree to which these companies are able to provide the kind of help that is needed in the diverse communities where clients reside, especially to those individuals who face multiple barriers to employment and who need long-term psychological and vocational support.

The paucity of good data on the comparative performance of nonprofit and for-profit service providers has led public managers to focus on the one area where data is available, namely, cost. Many managers are drawn to the idea that cost should be the central factor in contracting decisions since measuring and comparing costs across proposals is far easier than making tough judgments about the quality of underlying service models or the qualifications of the providers. Political pressures and demands for fairness in the allocation of contracts also tends to push public managers to focus on service cost as the critical criterion in contract allocation. To focus entirely on the cost of service provisions is, however, to set up a contracting system that will have the inevitable effect of favoring business firms over nonprofit organizations.

Without a more complex and sophisticated set of criteria, the long-term consequence of such an unreflective approach to contracting is likely to be the slow squeezing out of nonprofit providers from certain fields. This sort of ecological shift might seem to be a small price to pay for the ability of the public sector to economize on the costs of service delivery. However, there may well be unforeseen consequences to this kind of reorganization of sectoral responsibilities. Chief among these is the permanent disappearance of the "nonprofit option." In fields such as nursing home care, where for-profit market penetration has been deep and complete, it is hard to conceive how a mixed ecology can ever be restored. The sectoral shift in nursing homes was accomplished to achieve economies, but it ultimately has had the effect of driving out nonprofit providers. Once a field has been purged of

nonprofits, even if consumers want to restore a nonprofit option, policy makers may be unable to take meaningful action, since the barriers to re-entry for nonprofits are very high and play into the sector's weaknesses in terms of mobilizing blocks of capital.

Because of the difficulty in reversing major ecological shifts in the organizational population, public managers need to radically expand the quality and breadth of their conceptual frameworks for thinking about large contracting decisions. This can be accomplished by developing a set of analytic tools for understanding when and why either nonprofit or for-profit provision is likely to work best, based on the characteristics of providers, the needs of consumers, and the nature of the underlying service. Until a compelling conceptual framework for deciding the division of labor across sectors emerges from the slow accretion of reliable data, protecting the mixed ecology of service providers will require a shift in the underlying criterion used by many public managers in the awarding of contracts.

There are many possible public sector criteria for the awarding of service contracts, but three stand out in particular. First, government may continue to use cost efficiency as a measuring stick for choosing between providers. Second, government contractors may choose to focus on program effectiveness in awarding contracts to service providers. By looking at an organization's track record for achieving client outcomes that are meaningful, government funders should be able, in principle at least, to focus resources on organizations that have proven that they can deliver quality results in their chosen field. Finally, government may seek to emphasize innovation methodological diversity as prime factors in the awarding of contracts, especially in fields where knowledge is not settled and where further experimentation is needed. In so doing, public managers would affirm the value of pluralism and its many dimensions and implications. A good case can be made for shifting toward the third criterion, while still taking seriously the first two.

In the face of considerable uncertainty about the relative performance of nonprofit and for-profit providers, the wisest

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course of action today comes down to the affirmation of the value of pluralism and provider diversity. Although it may well be possible to fuel a race to the bottom by allowing for-profit service providers to bid down contracts to the lowest possible margin, such an approach may alienate clients and consumers, especially in many areas where the quality of care is critical. Similarly, while it may be possible to structure a market comprised only of nonprofit providers in which the competition might be principally focused on programmatic quality and responsiveness, this route would likely raise concerns about cost containment. Given the difficulty of ever reversing major ecological shifts, public managers must tread carefully. Keeping in sight cost and quality considerations, a sensible and practical policy objective for the public sector is the preservation of a market of service providers that is mixed, where for-profit and nonprofit providers compete along multiple dimensions.

III. Policy Options for Managing the Complex Organizational Ecology

As public managers and policy makers consider the task of preserving in many fields a mixed organizational ecology of nonprofit and for-profit service providers, some modest steps can be taken to ensure that nonprofits are not unduly disadvantaged in the competition for service contracts. Two of the five nonprofit competitive disadvantages described earlier can be addressed through modest policy changes.

Modest Measures

In the area of helping nonprofits to overcome some of the limitations they face in terms of meeting the scale and financing demands of large public contracts, one possible solution to the differences between the two sectors is to require that major public contracts be structured so as to explicitly encourage or require the use of local subcontractors. In many fields where direct client services are rendered, neighborhood knowledge and legitimacy are critical and require community connections established over a long period of time. To capture this knowledge and to help

nonprofits bid on contracts that may seem too large for any single organization to handle, public managers may want to consider structuring service contracts in a way that rewards bidders who propose to rely on experienced subcontractors. In so doing, government might have to trade some efficiency away for the benefits that smaller, more locally connected organizations might bring. By breaking large projects into smaller, more manageable projects, public managers could take a critical step toward removing a key barrier to nonprofit participation.

A different option for overcoming the scale limitations of many nonprofit organizations is the facilitation of mergers.²⁵ At present, large numbers of nonprofit organizations operate without much grasp of the organizational landscape around them. Often several nonprofits are providing services in a relatively narrow geographical territory, while other areas are left untouched. To help nonprofits compete for contracts that require a heightened level of integration and scale, proposals at the state level have been put forward to create "consolidation funds" that would reward nonprofits that merge operations and reduce some of the overlap and inefficiency. Because much of the law bearing on the disposition of charitable assets is administered by state attorneys general, any such reform effort would have to proceed incrementally on a state by state basis. While the idea of achieving scale through state-aided consolidation appeals to some nonprofit managers, to others the idea is fraught with problems, including the incompatibility of nonprofit missions, the culture of decentralization within many organizations, and the resistance of managers and boards to surrender control.

In the area of capitalization, some action is also possible. Beyond opening up opportunities to secure tax-exempt bonds, government can play a role in helping nonprofits to overcome their lack of easy access to capital by creating pools of public funds that can be used by enterprising nonprofits to overcome some of the barriers to entry that are present in certain contracting areas. In the charter school arena, for example, the U.S. Department of Education recently established a fund to help new charter schools locate the

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start-up resources necessary to be able to plan and open a school. This fund was created when many cities and states found that the charters they had issued were going unclaimed because few nonprofit entrepreneurs could figure out how to acquire a school building and overcome the initial costs associated with creating a new school. This problem was created by the fact that the only funds available to many charter schools were per pupil allocations that were payable at the start of the school year. This created a serious cash flow problem for charter schools. The solution, though simple, has relevance in the many service fields where government payments are keyed to program enrollment or to the achievement of specified client outcomes. To be able to compete with business firms that have the capacity to overcome these short term cash flow challenges, nonprofits may need an array of startup funding sources that will enable mangers to cover the costs associated with entering a field where government service delivery contracts are available.²⁶

Some nonprofit managers have recently begun to explore the possibility of securitizing accounts receivable. Rather than using real estate and buildings to acquire working capital, it may be possible for some nonprofits to raise funds not by securing them with facilities but with accounts receivable, perhaps in the form of long-term government contracts. This idea has remained on the drawing table largely because few government contracts are long-term enough to satisfy lenders, and because there is a general sense that government contracts can be revoked if an organization fails to perform well. One way public managers could assist nonprofits in securing financing, be it through the securitization of accounts receivable or through conventional loans, is by making their contracts longer and more dependable. Of course, any change in this direction removes some of the government's flexibility in contracting for services.²⁷

Seeking Balance

As public managers look out at the changing service contracting landscape and work to address some of the challenges that

nonprofit organizations face to full and fair participation in the service contracting marketplace, a bit of balance may well be in order. Although many human service nonprofit organizations now portray themselves as David facing the corporate Goliath, the moral basis of the nonprofit sector's plea for help is weakened to some extent by the range of advantages that nonprofit organizations enjoy: exemption from taxation, the ability to offer contributors a deduction for their contributions, exemption from property taxes, and subsidized postal rates. While many of these special privileges do not bear directly on the ability of nonprofits to secure government service contracts, the subsidies received by nonprofits do allow them to conduct commercial activities that generate revenues that can be used to reduce the costs of service delivery.

As a consequence, business lobbies have argued that nonprofit organizations require a far more differentiated tax treatment than they presently receive. One approach that has been considered is the granting of a sliding scale of tax benefits to nonprofits depending on the level of public service they deliver. Under such a plan, donors to soup kitchens might receive a full tax deduction for the gift, while supporters of more commercialized nonprofits such as a hospital would only receive a partial deduction. Similarly, some nonprofits would enjoy the full postage discount while others would be forced to pay closer to the market rate. The problem, however, with any such arrangement designed to differentiate between nonprofits based on the social benefits generated is that it puts government in the awkward position of judging the social value of the missions of public charities, a responsibility that would be hard to discharge fairly.

Business groups have been joined recently by local municipalities in seeking to open up the question of why all nonprofit organizations enjoy exemption from property taxes. From the perspective of business, the ability of nonprofits to avoid contributing to local tax receipts imposes on local businesses an unreasonable and unfair burden, one which can render the playing field less than balanced. The ability of very large institutions and

highly commercial nonprofits to operate free from property taxes has led many cities to begin to investigate ways to ensure that financially successful nonprofits are not allowed to enjoy a free ride at the expense of other taxpayers. One option that is now being explored in Baltimore is a sliding scale that would seek payments in lieu of taxes – ranging from nothing to several million dollars, depending on the resources of the nonprofit organization.

The high ground of nonprofits has also been eroded by another significant recent trend: the sharp and continuing rise in unrelated business income activity within nonprofits and the meager amounts of taxes paid by nonprofits on these revenues. A growing number of nonprofit organizations have established ventures or enterprises that bear no real connection to their core charitable missions, but that nevertheless generate a stream of income that can be used for social purposes. The regulation of these "unrelated businesses" has increased in recent years as competitors in the business world have raised complaints about unfair competition. When revenues are derived from an enterprise that is "not substantially related to the mission" of the nonprofit, a tax in principle is applied by the IRS. The unrelated business income tax (UBIT) is intended to limit the expansion of nonprofit enterprise into areas that businesses occupy or, at least, to level the playing field. The range of unrelated businesses operated by nonprofits is enormous and can include everything from a bakery operated by a youth center to a real estate development firm operated by a university.

As unrelated commercial activity by nonprofits has increased in recent years, a difficult problem related to enforcing rules to protect fair competition has arisen. At the same time as nonprofits engage in greater levels of commercial ventures, each year the amount of profit they report remains very low, and hence, the taxes they pay on their unrelated business have stayed relatively low. The best explanation for this phenomenon lies in the clever accounting techniques employed by nonprofits that allow these organizations to report either minimal gains or even losses with regard to the generation of the unrelated income. This is possible by shifting costs from program-related activities to commercial

ventures. In other words, as nonprofits have created flows of income from ventures that sometimes compete directly with forprofit firms, they have learned to move staff, overhead, and capital expenses from the program side of the balance sheet to the commercial side. As this cost shifting occurs, any profits generated by unrelated business activity are quickly turned into losses.²⁸ Through this cost shifting, the tax liability of nonprofits is often reduced or eliminated. The IRS has grown suspicious of this practice, wondering why nonprofits continually engage in activities that lead to losses.²⁹ Of course, the answer is that often profits are being made, but the rules designed to level the playing field between business and nonprofit enterprises are being circumvented with increasing frequency.³⁰

To counter this trend, greater enforcement of UBIT regulations and higher levels of oversight by the IRS may be needed to ensure that nonprofit organizations report their financial results accurately. One way to accomplish this would be to bring greater order to nonprofit reporting by improving the generally poor standards guiding nonprofit financial accounting.³¹ Today, only nonprofits receiving a total of \$300,000 or greater in government grants and contracts are subject to an A-133 audit.³² For nonprofits below this threshold, the level of oversight with regard to their financial statements is extremely low. Building a stronger, more reliable accountability system³³ would go a long way toward satisfying business that nonprofit organizations are not taking undue advantage of their tax-exempt status.

Conclusion

In the end, as the division of labor between sectors works itself out, policy makers can take a few steps toward ensuring that the nonprofit option is not lost and that pluralism as a value in service delivery is protected. Helping nonprofits access capital and opening service contracts to subcontractors might well help to ensure that nonprofits are not shut out of contracts that require large-scale operations and technical capacity. In fields such as welfare-to-work, where the scale of some of the contracts can be immense, the vast universe of community-based nonprofit providers are at a real disadvantage. Without some action, the

public sector may ultimately lose out on the special skills and local contacts that many of these small service providers possess. On the business side, clarification of the line between related and unrelated income would be welcome by almost everyone, as would a more effective oversight of the financial reporting of nonprofits. The lack of clarity in nonprofit financial reporting practices will lead to an erosion of public confidence in nonprofit organizations if left unattended for much longer.

The calm and peaceful world that may once have existed for nonprofit service providers is now long gone. Market pressures have penetrated the nonprofit sector in important ways that cannot help but change the sector and the way government purchases human services. As these changes take hold, it is clear that the scope and character of human services will be impoverished should nonprofits continue to lose out as the trend continues toward greater and greater business activity in fields traditionally dominated by nonprofits. Even if data on the comparative performance of the sectors is inconclusive in many fields, almost everyone should be able to agree that in fields like early childhood education, community health, and job training, where knowledge about what works continues to be highly contested, it remains desirable to invest in a plurality of approaches across sectors. With their unique commitments and value-laden missions, nonprofit service providers have the ability to continue to offer innovative approaches to public problems that are linked to community needs and standards. With a strong commitment to results and the bottom line, business firms also have something valuable to bring to the market for government service contracts. Until greater data and conceptual clarity emerges about the comparative advantages of nonprofit and for-profit service delivery, government at the federal, state, and local levels should take small measures that will help preserve a mixed organizational ecology in which both nonprofit and for-profit providers play a role in the changing landscape of human service provision.

Endnotes

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- 14 On the distinctive nature of nonprofit organizations, see Henry Hansmann, "The Role of Nonprofit Enterprise," The Yale Law Journal 89 (1980): 835-98; and Henry Hansmann, The Ownership of Enterprise (Harvard University Press, 1996).
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