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Advisory Letter

Finding Your Best Income Portfolio by Dennis R. Young

Unlike most businesses or governmental agencies, nonprofit organizations have no standard way of financing themselves. Indeed, the variation in nonprofit financing patterns is enormous. Some, like the Fox Theater in Atlanta depend virtually entirely on earned income (mostly from ticket sales); others like Medwish International based in Cleveland, which repurposes and distributes medical supplies and equipment to health care institutions in developing countries, depend for more than 80% of their income on charitable contributions of various kinds; still others like Good Shepherd Services, a social services organization in New York City, rely on government funding for the vast bulk of their income. Most nonprofits, however, depend on a variety of highly diverse mixes of income from these three sources, as well as income in the form of investment returns, volunteer labor, and gifts-in-kind. For example, the American Museum of Natural History relies on about a quarter of its income from contributions, about 10% from government, a third from fee income, and the rest from investments and other sources.

So it is not surprising that nonprofit executives commonly ask: What is the best income mix for my organization? I wish there was a simple, across-the-board formula to answer this question. Although certain sources of income seem fashionable from time to time (e.g,, commercial income from a "social enterprise"; building an endowment; crowd-funding; foundation grants; etc.) the reality is that there is no one best way to finance a nonprofit organization. Fortunately, however, there is a good way to *think about what is best for your organization*. It's called the *Benefits Theory of Nonprofit Finance.*

Don't be put off by the word "theory". The basic logic is simple, and a nonprofit executive can use its principles to build the financial foundations of her or his organization and maximize its capacity to address its mission. Like most things nonprofit, benefits theory starts with the mission of an organization and reflects the notion that the financing of a nonprofit organization should be customized to its mission. Here's how it works.

The mission of an organization, including its targeted group of beneficiaries, determines the kinds of good and services that the organization must produce. These services manifest themselves in different forms – what economists call various types of public and private goods. These different forms of goods and services are, in turn, amenable to different modes of financing. For example, a private good, like those commonly sold in the marketplace, are normally financed through sales revenue, while a collective or public good like a food bank to serve the hungry or a river cleanup campaign requires charitable donations and volunteers or, if it has widespread support, perhaps government grants. In benefits theory, we envision four general types of goods and services: *private goods*; *group goods* which collectively and simultaneously benefit a certain identified population; *public goods* which collectively serve a broad constituency; and *exchange goods* which benefit certain "partner" groups or organizations which in turn can support the organizations through various kinds of payment. There are some subtle variants of these kinds of goods as well; for example, private goods that are provided explicitly for low income populations, such as affordable housing, have a public (or re-distributional) component as well. Nonetheless, once we have a sense of the kinds of goods the organization produces, we can then begin to outline the best mix of financing. In broadest outline then, private goods can be supported with fees; group goods with charitable contributions; public goods with government support; and exchange goods with partnerships. Thus, the mix of services directly suggests the desired pattern of financing. Alternatively, the desired or ideal pattern can be compared with the organization's actual income portfolio, to see how well it aligns with it, and to identify potential sources of income not yet sufficiently exploited.

The application of benefits theory to any individual organization of course requires nuanced examination of the organization's mission, services, beneficiaries, and its capacities for administering the various sources of income at a given point in time. But to see how this might work to broaden and strengthen a nonprofit's financial foundations as it undertakes to address its mission more effectively over time, consider the following stylized example. I will use Cleveland as the setting, because this is my home, but the example is really generic:

Suppose it is baseball season and the members of a local Y or JCC desire a program to teach baseball skills to their children. How to throw, run, catch, hit a ball, etc. Skill lessons are essentially a private good which can be paid for with fees by parents of participating children. So far so good, but the Y doesn't have a practice field so lessons must be confined to its gym. It would be better to have a field in order to expand instruction on base running, hitting and fielding skills. A local neighborhood park is available but it's in bad shape. So the Y considers cleaning it up and putting in an infield and backstop and some benches for onlookers. This investment would clearly benefit not only the participating children and their families, but also residents of the neighborhood who could enjoy a cleaner park and watching the kids play ball. This is a group good that might be financed through a combination of financial gifts and volunteering, by local residents, organizations and volunteers. Now the Y has a broader income portfolio for the program, but it can go further. Suppose the program is noticed by people in other neighborhoods who would like such a program in their own areas and for their own children? And suppose local government has an interest in making the program available to children whose parents cannot afford to pay the full fee? This suggests that government support might be engaged in the form or a grant or contract to extend the program beyond the local neighborhood and into other parts of the city. Now we have

the main sources of nonprofit finance engaged: fees, contributions, volunteering and government support involved. And there might be another: Suppose that our hometown Cleveland Indians took note of the program and decided it would be good publicity to support it, and perhaps to gain dibs on local talent – kids that might eventually make it to the big leagues. In exchange, the Indians could provide uniforms, equipment and perhaps grants to build the capacity of the program.

This example illustrates how mission can be translated into services and beneficiaries, and ultimately a diversified income portfolio, in order to build the financial foundations of a nonprofit organization. Benefits theory provides a logic to diversification and choices of income streams. Income diversification in itself can be an important component of nonprofit risk management strategy, as others will discuss in future columns. But diversification should be undertaken not for its own sake, but rather with a logic that benefits theory can help provide.

For details on the benefits theory of nonprofit finance, see:

Dennis R. Young, *Financing Nonprofits and Other Social Enterprises*, Edward Elgar Publishers, 2017 (https://www.e-elgar.com/shop/financing-nonprofits-and-other-social-enterprises)