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Helping nonprofits make wise economic decisions

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Economic Thinking in a Time of Crisis

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Since the time of Thomas Malthus, an 18th century economist who predicted that the world would starve as population outgrew the food supply, economics has been called the dismal science. In today's dismal time of the COVID-19 pandemic, perhaps it is appropriate for economics to brighten its reputation by helping to address some of the problems we are now experiencing. In particular, nonprofit organizations in the U.S. and in other countries are facing severe, indeed existential economic challenges. Many organizations have had to close their doors at least temporarily, cancel fund raising events, furlough staff, move to on-line operations and take other severe measures in order to survive and to comply with policies to protect public health. Others, such as foodbanks and hospitals, are hard-pressed to address new demands for services to vulnerable groups affected by the crisis.

In these circumstances it is ever more important that nonprofits use their scarce resources as efficiently and effectively as possible. That, in a nutshell, is what the discipline of economics is all about. Along with many colleagues, I believe that application of basic principles of economic thinking can help nonprofit leaders make better, even transformative decisions in order to survive the current crisis and position themselves for brighter days ahead.

Allow me to illustrate this point by applying economists' ideas about "cost". Many nonprofit organizations are in trouble now because they have high *fixed costs*, that is substantial costs that continue to be incurred whether or not output or service is being produced. Such costs include maintaining physical plant and equipment, and paying core salaried staff on long term contracts. In a crisis, fixed costs are a problem for nonprofits that receive their revenues from sales, fees or reimbursements for services rendered. If that revenue is curtailed, fixed costs cannot be proportionally reduced in order make ends meet.

It is true that the investments that give rise to fixed costs are essential to many kinds of nonprofits, for example universities with campuses, and museums and hospitals with their specialized facilities and staffs. However, in many cases trade-offs can be made between fixed

and *variable* costs in order to gain flexibility without sacrificing mission. Performing arts organizations can ask whether they need their own concert venues versus performing in schools and churches that may have available space, or how large an in-house ensemble is required versus engaging some itinerant performers. Youth organizations may question if they need their own buildings vs. meeting in schools and churches. Even religious congregations can question whether they need their own sanctuaries or can operate within other structures.

These are difficult decisions but many nonprofits have converted their (actual or potential) fixed costs into variable ones successfully. *Girls Inc.* and *YWCA/Cleveland* were once facility-based programs but are no longer so. Scouting organizations have sold many of their extensive outdoor camps. In Cleveland, Ohio the early music orchestra *Apollo's Fire* successfully performs in multiple church, school and museum venues, employing a core group of musicians and enhancing that core as needed with highly accomplished traveling early music specialists. Alternatively, it would be hard for the *Cleveland Orchestra* to do this because so much of its identity is tied to Severance Hall and its large permanent ensemble. Nonetheless, many more nonprofits should think through their fixed versus variable cost decisions in order to be better prepared for future crises that may shut down or reduce their operations for a substantial period of time. (Indeed, economists argue that a nonprofit could continue to operate as long as its average revenue exceeds its average variable cost because in this circumstance it can at least partially offset its fixed cost.)

Another helpful concept is *sunk cost* which are costs incurred in the past that have no bearing on future decisions. In general, economic decision making should focus on the future, not the past. Nonprofits can be misled by sunk costs, especially investments they may have made in programs that have not proved their worth. Do you repeat an annual fund raising event even if it has lost money in the past? Do you continue to offer a program just because you've invested heavily in research and marketing to promote it, even if it is failing to achieve its goals? Sometimes there are good reasons to continue such programs, but *not* to try to recoup sunk costs. A thrift shop that loses money may engage volunteers that care deeply about it and who are loyal supporters of the organization. An annual golf tournament may have sentimental value for donors and volunteers even if it doesn't raise any net funds. In such cases, one should think about how these benefits compare to those that could be achieved if the resources were deployed differently. Those volunteers might be more productively engaged doing something else.

The notion of alternative uses of scarce resources (like those volunteers) lies at the heart of economists' understanding of cost. Indeed, economists would say that *all costs are opportunity costs,* because the value of a resource is simply what it is worth in its next best alternative use. In nonprofit decision making it is often worthwhile applying this definition directly. For example, in current circumstances, volunteers sheltered at home may be enlisted for helping with on-line tasks, at very low opportunity cost. Another good example is how nonprofits constrain

the funds that they receive. If funds are tied up in an endowment, the corpus is not available for current use, indicating that future benefits are provided at the expense of present needs. Often this is appropriate, for example if the organization's mission is ongoing and if fixed costs require an offsetting stream of fixed revenues.

But tying up funds in endowments or with other restrictions can come with large opportunity costs in present circumstances. For example, most nonprofits do not maintain adequate reserve funds to cover long shutdowns. For the future, many nonprofits need to reassess this balance, providing for present day emergency needs before tying up capital restricted to producing long term future benefits. This may be more difficult to negotiate for donor-restricted funds than for endowments that are board-designated, but the issue is the same.

Nonprofit leaders may be limited in what they can do right away to cope with the present crisis but they need to begin planning for the next emergency *now*. Reassessing their fixed vs. variable cost structure, avoiding the trap of sunk costs, and carefully considering the opportunity costs associated with restricted funds and endowments, are three important examples of such reassessment. More broadly, *applying the basic ideas of economic analysis to nonprofit decision making now will help assure that nonprofits can make the best use of their resources, both now and in the future*.

Towards this end, the Research Advisory Network (RAN) of the National Center on Nonprofit Enterprise (see https://nationalcne.org) is offering advice on key economic challenges associated with the current and future crises. RAN is a group of some 50 nonprofit scholars across the U.S. who specialize in nonprofit economics and decision making. Promoting economic thinking in the nonprofit sector is also the reason my colleagues Richard Steinberg, Rosemarie Emanuele, Walter Simmons and I wrote the second edition of *Economics for Nonprofit Managers and Social Entrepreneurs* (see https://www.e-elgar.com/textbooks/young/). We believe that economic analysis is a necessary part of a complete education for nonprofit managers and leaders, and should be applied in day to day management, over the long term, and *immediately* in crises such as the one we are now experiencing.

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