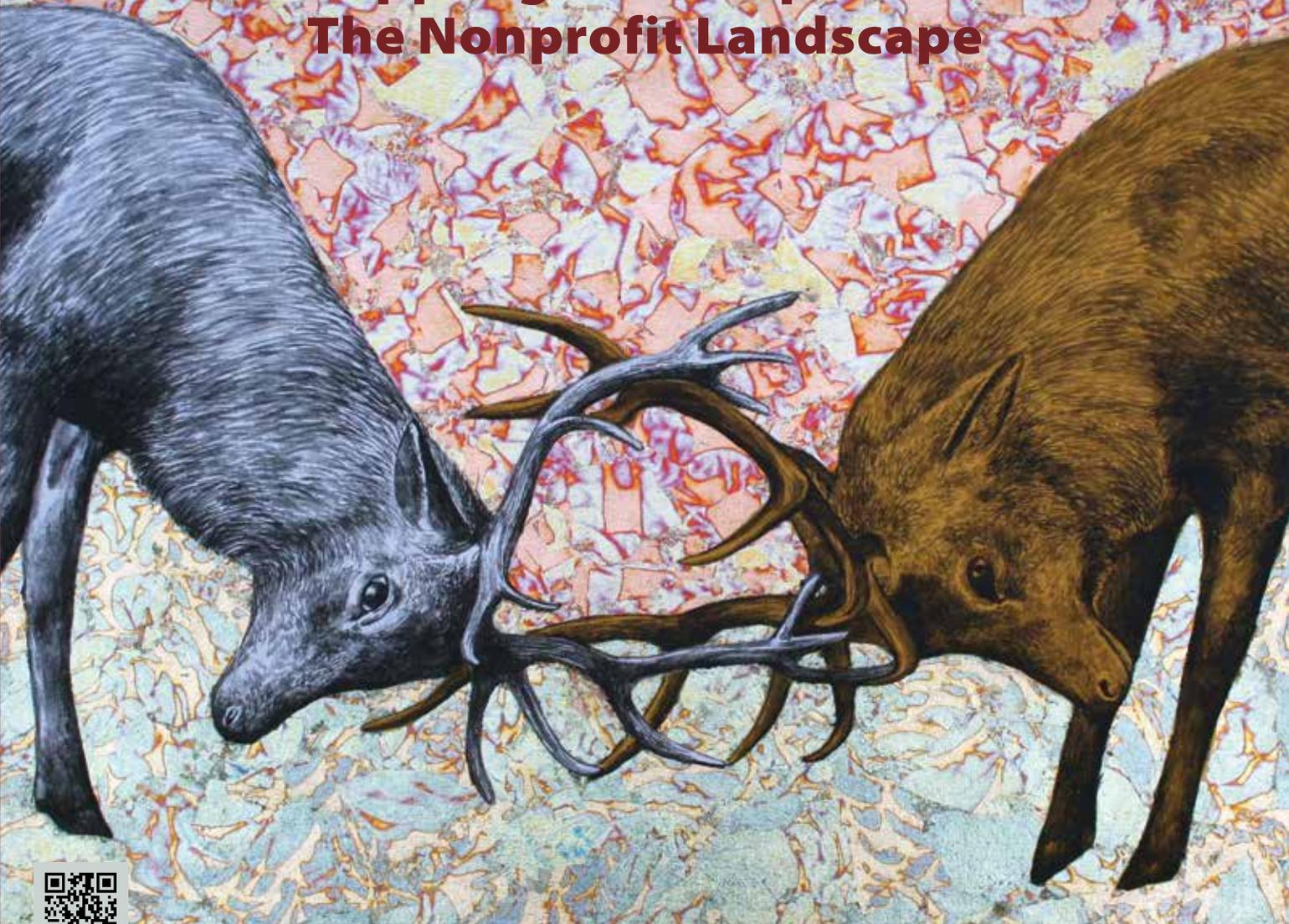


THE Nonprofit QUARTERLY

Grappling with Competition: The Nonprofit Landscape



Kochan *on* the Impact of Market Basket

Cabin *on* the Problem with
For-Profit Healthcare

Frumkin and Sosa *on* Competitive Analysis
for the Social Impact Leader



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Welcome

DEAR READERS,
Welcome to the fall issue of the *Nonprofit Quarterly*. This edition is full of thought-provoking articles about competition in the nonprofit sector, addressed from a number of different vantage points.

Peter Frumkin and Suzi Sosa have contributed an article on how measuring your opportunities for social impact success is dependent on *really* knowing your competition. As is the case with any contribution by Frumkin, the article very thoroughly covers the points of practice. How do you understand your market and survey your competition within that context? In other words, what goes into a thorough competitive analysis? Your board should see this article.

Under the heading “competition for *what?*,” we have an interview with codirector of the MIT Sloan Institute for Work and Employment Research Tom Kochan, talking about markets and corporate control vis-à-vis a tussle between stakeholders and shareholders of the corporation Market Basket. This article may help change some of your most basic assumptions about what creates organizational sustainability.

Michael Lombardo challenges our notions of “scale” and the implied connection between organizational size and success, in “Are We ‘Walmartizing’ the Social Sector?,” and Gene Takagi and Tony Wang examine the laws that govern nonprofit versus for-profit competition when for-profits feel their business is being threatened. They look at particular fields—recreation, dental and veterinary clinics—and cover the legal ground surrounding the disputes.

On the flip side of that is an article by William Cabin that suggests that in some fields—specifically hospice, home healthcare, and nursing homes—for-profits perform at a lower level and at higher cost than nonprofits, and that this should potentially be taken into account by government funders.

Finally, we have a one-of-a-kind investigative article by Rick Cohen looking at how the brand new field of health cooperatives funded under the Affordable Care Act has performed against highly competitive and well-developed existing health insurers.

As always, we hope that you find this edition thought provoking and helpful. Let us know what applications you find!





The Nonprofit Ethicist

by Woods Bowman

Accumulating millions in endowment returns is not unethical if they are being reserved for legitimate reasons. If an accountant notices that a client has a going concern problem, he or she is obligated to request the client's capitalization and financing plans for the long term—awkward as this may be. And, while not strictly illegal, there is indeed a conflict of interest when the board of a membership organization also serves as the board of the organization's daughter nonprofit.

DEAR NONPROFIT ETHICIST,
I recently learned that the board of directors of my agency has for the last ten years followed a policy of not spending any of the yearly returns from its endowment of around \$10 million. I do not know what goes on in board meetings but I hear that successive finance chairs are proud that they have grown the endowment through the recession and that the executive director supports the policy. Isn't the main purpose of an endowment to generate interest income for program expenses? We rattle the can so we can prevent families from becoming homeless, while every year about \$200,000 of the money that could be going to programs is instead getting plowed back into Wall Street. I'm not talking about touching the endowment principal, and I know our board's policy isn't illegal, but is it ethical? I just hope we can spend some of the money on our mission.

Hopeful

Dear Hopeful,
 There are many people who would say that this behavior is unethical. However, I am inclined to be cautious. The board may be reserving a portion of this pot of money to smooth monthly cash flow (working capital). It may be reserving another portion to cover unexpected budget shortfalls (operating reserve). Or it may be saving for an extraordinary expenditure, such as buying a new building or rehabilitating your existing physical plant without borrowing (capital reserve). These are legitimate choices. If your agency is very large and its regular income is volatile, even \$10 million may not be sufficient. However, it is important that the board have a plan for the money. If you ask enough questions, maybe the executive director and board members will focus their attention on the reasons for accumulation.

By the way, spending policy should be expressed in terms of total return (interest plus dividends and capital gains or losses), not in terms of interest alone. Furthermore, it should be based

on average returns over several prior years—never on the current year alone.

Dear Nonprofit Ethicist,
I have new clients who have to have an audit and were referred to me. They gave me their QuickBooks file on USB and a box of bank statements, paid invoices, billing statements—all in order. Before doing anything else I e-mailed them with a request for other information I knew I would need to look at and document. So far so good, right?

Within five minutes of downloading their company file and looking at their unadjusted financial statements, cash in bank, etc., it was evident to me that they had a going concern problem. I always hate to use the word "problem," but this could be terminal—as in, they probably wouldn't last another six months without a major source of funding. Overall, that usually doesn't have to be a "problem" (hey, it happens sometimes, right?). It most likely will, however, lead to a modification of the auditor's report as well as the footnotes to the financial statements.

Again, it happens. Nobody is 100 percent successful 100 percent of the time. Here's where it gets weird (and all this happened over the course of a week): They included the minutes of the board of directors' meetings with their initial documents. Urgency of the matter was indicated but was never the overriding theme of any of the meetings. I sent the treasurer of the board of directors and the executive director an e-mail. Very diplomatically and in a non-confrontational manner, I asked if we could set up a meeting to discuss the organization's capitalization and financing plans for their present and future growth.

They responded with an e-mail consisting of a polite salutation and an attachment of some information I had asked for earlier—nothing more.

I sent them another e-mail, rephrasing my request for a meeting, again very nonconfrontationally and indicating respect for their organization and mission.

They responded with another e-mail, again addressing me politely, with some other bit of information attached that I had requested earlier, and again completely ignoring my request for a meeting. This went on for one more round of e-mails.

They know what I am driving at. They don't want to address or discuss it. They are frightened. They may think I am sending them all to jail.

They have promise and I want to help them. I don't want to tell them they are failing or that their means of fulfilling their mission is organically unsustainable. That is something they already know—or should know. I don't want them to think I consider them worthless. And I certainly don't want them to think I am sending them to jail.

What to do?

Puzzled

Dear Puzzled,
Sometimes you have to shake your head and wonder, "What are they thinking?" I also wonder why they needed a new auditor. Coincidence? Anyway, you have a definite obligation to break the bad news to them. Tell them that, based on a preliminary review of their records, you have doubts about their ability to remain a going concern. Professional standards (AU-341.03b) require you to "(1) obtain information about management's plans that are intended to mitigate the effect of such conditions or events, and (2) assess the likelihood that such plans can be effectively implemented."¹ Maybe they are just too embarrassed to talk face-to-face, so ask for a written plan. I assume such a plan does not exist, but it would be to their benefit to develop one, put it in writing, and obtain their board's approval. This could be the jolt they need.

Dear Nonprofit Ethicist,
Some years ago, a membership association established a charitable nonprofit to receive grant funding from the state and federal government. The members of the association's board also serve as members of the charitable nonprofit's board. The officers of one do double duty as officers of the other. I worry that this arrangement is rife with conflicts of interest. The chairman of the board and the president of the association are the same person, and he says it isn't. What do you say?

Worried

Dear Worried,
This is a tricky (but not a trick) question. In the classic sense, a conflict of interest is a personal financial interest that is inconsistent with the duty of loyalty board members have to their organization. (Appendix A to instructions for the Internal Revenue Service's Form 1023 gives a sample conflict-of-interest policy in the

classic tradition.²) In this sense, the chairman/president/whatever is right. However, I believe the classic view is too narrow.

In my view, whether the situation you describe poses a conflict of interest turns on the purpose of the daughter nonprofit. (You should be able to find the nonprofit's purpose spelled out in its articles of incorporation and bylaws, and on its Form 1023.) If the nonprofit's purpose is very broad, there is ample scope for conflicts of interest when decisions are made about applying or not applying for particular grants, and how to spend unrestricted gifts to the nonprofit. However, if the nonprofit is designed specifically to support the work of the membership association and has no programs of its own, the governance structure you describe poses no conflicts. For audit purposes, however, it would still be worthwhile to have separate organizations.

NOTES

1. D. Larry Crumbley, Zabihollah Rezaee, and Douglas E. Ziegenfuss, U.S. Master Auditing Guide, 3rd ed. (Chicago: CCH Incorporated, 2003). <http://www.aicpa.org/Research/Standards/AuditAttest/Downloadable Documents/AU-00341.pdf>.

2. Internal Revenue Service, *Instructions for Form 1023*, Appendix A: Sample Conflict of Interest Policy (revised June 2006), <http://www.irs.gov/pub/irs-pdf/i1023.pdf>.

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Ask the Ethicist about Your Conundrum

Write to the Ethicist about your organization's ethical quandary at feedback@npqmag.org.

Just So Much and No More

by Donella Meadows

The laws of economics say, “Grow . . . Compete . . . Use it up fast . . . Take it now and turn it into dollars . . . Do whatever makes sense in monetary terms.” The laws of the Earth say, “Just so much and no more . . . Compete, yes, but keep your competition in bounds . . . Never take more in your generation than you give back to the next.” Only time will tell which laws eventually prevail, and the consequences we will suffer if we do not make our economic laws consistent with our planetary ones.

Editors’ note: Every issue of the Nonprofit Quarterly begins with a framing article that in one way or another puts the edition’s focus into context. As we prepared this edition on the function of competition in the nonprofit sector, we recognized the importance of including something about the framework we use to understand competition, because there are two that can be seen as being at odds with one another. One framework recognizes that competition is useful within bounds but insufficient to guide economies; another is what we might call a “scorched-earth” approach. What follows is the last column of ecologist Donella Meadows, who died suddenly of meningitis on February 20, 2001. Meadows wrote extensively about economic systems and sustainability, and wrote and worked tirelessly on behalf of the Earth. We offer this column, which was first published on June 30, 2001, in Yes! Magazine, as macro context for this edition. We thank the Donella Meadows Institute (www.donellameadows.org) for their kind permission.

THE FIRST COMMANDMENT OF ECONOMICS IS: Grow. Grow forever. Companies must get bigger. National economies need to swell by a certain percent each year. People should want more, make more, earn more, spend more—ever more.

The first commandment of the Earth is: Enough. Just so much and no more. Just so much soil. Just so much water. Just so much sunshine. Everything born of the Earth grows to its appropriate size and then stops. The planet does not get bigger, it gets better. Its creatures learn, mature, diversify, evolve, create amazing beauty and novelty and complexity, but live within absolute limits.

Economics says: Compete. Only by pitting yourself against a worthy opponent will you perform efficiently. The reward for successful competition will be growth. You will eat up your opponents, one by one, and as you do, you will gain the resources to do it some more.

The Earth says: Compete, yes, but keep your competition in bounds. Don’t annihilate. Take only what you need. Leave your competitor enough to live. Wherever possible, don’t compete, cooperate. Pollinate each other, create shelter for each other, build firm structures that lift smaller species up to the light. Pass around the nutrients, share the territory. Some kinds of excellence rise out of competition; other kinds rise out of cooperation. You’re not in a war, you’re in a community.

Economics says: Use it up fast. Don’t bother with repair; the sooner something wears out, the sooner you’ll buy another. That makes the gross national product go round. Throw things out when you get tired of them. Throw them to a place where they become useless. Grab materials and energy to make more. Shave the forests every 30 years. Get the oil out of the ground and burn it now. Make jobs so people can earn money, so they can buy more stuff and throw it out.

*“Some kinds of excellence
rise out of competition;
other kinds rise out of cooperation.
You’re not in a war,
you’re in a community.”*



“GLORIOUS” BY LOUISE MCNAUGHT/WWW.DEGREART.COM/USERS/LOUISE-MCNAUGHT

The Earth says: What’s the hurry? Take your time building soils, forests, coral reefs, mountains. Take centuries or millennia. When any part wears out, don’t discard it, turn it into food for something else. If it takes hundreds of years to grow a forest, millions of years to compress oil, maybe that’s the rate at which they ought to be used.

Economics discounts the future. Ten years from now, \$2 will be worth \$1. You could invest that dollar at 7 percent and double it in ten years. So a resource 10 years from now is worth only half what it’s worth now. Take it now. Turn it into dollars.

The Earth says: Nonsense. Those invested dollars grow in value only if something worth buying grows, too. The Earth and its treasures will not double in 10 years. What will you spend your doubled dollars on if there is less soil, dirtier water, fewer creatures, less beauty? The Earth’s rule is: Give to the future. Lay up a fraction of an inch of topsoil each year. Give your all to nurture the young. Never take more in your generation than you give back to the next.

The economic rule is: Do whatever makes sense in monetary terms.

The Earth says: Money measures nothing more than the relative power of some humans over other humans, and that power is puny compared with the power of the climate, the oceans, the uncounted multitudes of one-celled organisms that created the atmosphere, that recycle

the waste, that have lasted for 3 billion years. The fact that the economy, which has lasted maybe 200 years, puts zero value on these things means only that the economy knows nothing about value—or about lasting.

Economics says: Worry, struggle, be dissatisfied. The permanent condition of humankind is scarcity. The only way out of scarcity is to accumulate and hoard, though that means, regrettably, that others will have less. Too bad, but there is not enough to go around.

The Earth says: Rejoice! You have been born into a world of self-maintaining abundance and incredible beauty. Feel it, taste it, be amazed by it. If you stop your struggle and lift your eyes long enough to see Earth’s wonders, to play and dance with the glories around you, you will discover what you really need. It isn’t that much. There is enough. As long as you control your numbers, there will be enough for everyone and for as long as you can imagine.

We don’t get to choose which laws, those of the economy or those of the Earth, will ultimately prevail. We can choose which ones we will personally live under—and whether to make our economic laws consistent with planetary ones, or to find out what happens if we don’t.

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Stakeholders, Shareholders, and the Meaning of Market Basket:

An Interview with Tom Kochan

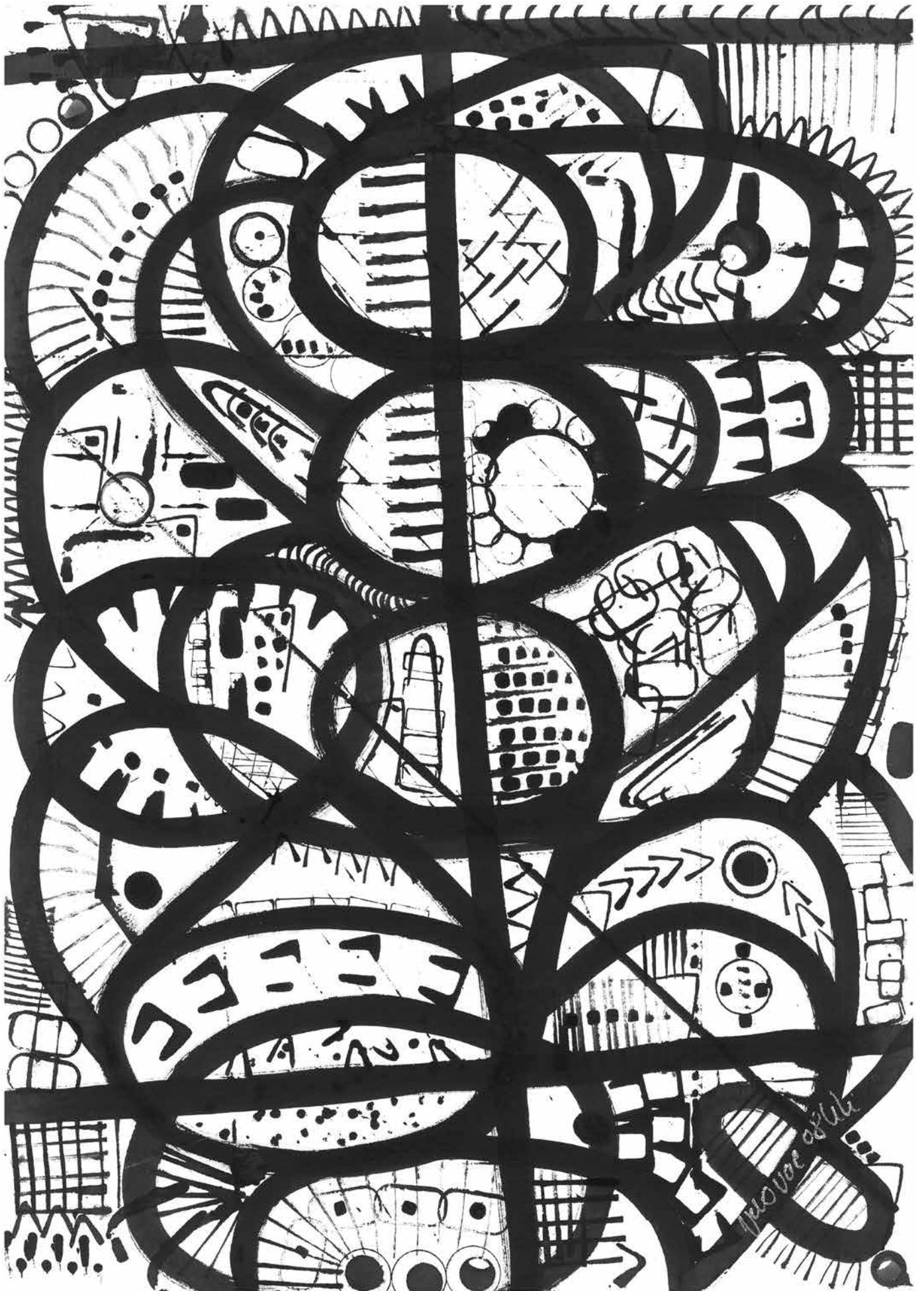
by the editors

The Market Basket protest against the shareholders' decision to oust their CEO is unprecedented—involving, as it did, the full workforce joined by the chain's customers and suppliers. But it is doubtful that this will be the last we see of this kind of action. It demonstrates an abiding concern in American society about inequality, bolstered by the development of social media and organizational transparency.

Editors' note: *Market Basket was a \$3 billion grocery chain in New England when, in July 2014, CEO Arthur T. Demoulas was ousted as the result of a family feud. One might have expected the story to end there. But, under Demoulas, Market Basket had paid its workers a fair salary and provided good product at low prices, and apparently its stakeholders had a sense of a shared future together: in an unusual demonstration of solidarity, they rose in protest. On August 27, after a six-week stalemate during which Massachusetts Governor Deval Patrick and New Hampshire Governor Maggie Hassan were moved to aid in the negotiations, a deal allowing Demoulas to buy out the rival family members' shares was ratified. The ousted CEO was reinstated—as were eight supervisors who had been fired for orchestrating the revolt and the thousands of employees who had taken part in it. Tom Kochan, codirector of the MIT Sloan Institute for Work and Employment Research at the MIT Sloan School of Management, believes that Market Basket is something of an indicator of things to come, as he explains in the following interview with the Nonprofit Quarterly.*

Nonprofit Quarterly: *Tom, we have talked previously about the larger implications of the stakeholder action around Market Basket and the potential impact of it. Can you talk about why you find it so notable with respect to your tracking of business trends?*

Tom Kochan: Well, it really is an unprecedented dispute, involving the full workforce of a business—that is, executives, store managers, clerks, warehouse workers . . . the full cross section—against the firing of their CEO and disruption of the business model that made the



“This is the full workforce saying there’s something fundamentally wrong when owners try to extract more of the profits from an organization and threaten the business’s continuity.”

business so successful, built a loyal customer base over the years, and provided good jobs. So it’s not a traditional labor-management situation where hourly workers are on strike or in a dispute with upper management. This is the full workforce saying there’s something fundamentally wrong when owners try to extract more of the profits from an organization and threaten the business’s continuity.

NPQ: *And the customers have also gotten involved in this. Have you ever seen a situation in which the workforce and customers are so united in this kind of action?*

TK: That’s another dimension to the story. It is quite unusual to have this broad base of loyal customers standing side by side with the workforce. They are absorbing higher costs by having to shop at more expensive stores. Some of them have limited transportation options, so it’s very problematic for customers. Yet they, too, value the long history of quality service and low prices that Market Basket is known for. This kind of action is not unprecedented, but it’s much more vivid and widespread in this case. You’d probably have to go as far back as the 1997 strike of UPS truck drivers, who built a coalition with their customers. Their customers didn’t boycott UPS, but they supported the drivers because they had a personal relationship with them. They got to know them as individuals, and they cared about them, and they related to the issue, too—because the UPS drivers were striking in part to preserve their pensions but also to gain job security, more options for full-time work, and fair salaries during a time in which American workers nationwide were struggling.

NPQ: *This relates to what’s been termed the “stakeholder/shareholder debate”—can you explain what that means?*

TK: Well, I think that over the last thirty years we’ve seen a strong trend in business education and business practice toward focusing on maximizing shareholder value as the purpose of the firm. In the past there had been more of a sense that the job of management was to balance the interests of multiple stakeholders—owners, to

be sure, but also employees and customers and suppliers, and maybe even the communities in which the business was located. That shifted in the 1980s, with leveraged buyouts and hostile takeovers and everything that followed in the wake of that movement. Since then, too many academics and business leaders bought into the notion that the corporation was solely an instrument for maximizing shareholder value. That, I think, is being challenged directly in the case of Market Basket, and I think the fact that it resonated so well with the public—with workers around the country—demonstrates that the protesters have struck a chord and that other people are equally fed up with the inequality in society, and attribute some of that to the greed of business owners or shareholders.

NPQ: *So do you see this as a rebalancing?*

TK: That’s what I think this represents. Clearly this is an idiosyncratic set of circumstances that led to the protest by employees; but it symbolizes this larger concern in society and has garnered widespread support from the public, the community members, and the vendors, who are suffering from the loss of business, as well as from the politicians, who intuit what this really might symbolize. So I think it does reflect a deeper concern and maybe even unrest in American society. It doesn’t mean that everybody is going to go out and do the same thing. Again, this is an unusual set of circumstances. But I do think others can relate to what these employees are doing, and they’re cheering them on.

NPQ: *You have mentioned seeing somewhat similar situations in China. Can you talk about that?*

TK: Well, in China they don’t have independent trade unions. The unions that exist are controlled by the Communist Party, and they’re an arm of the state, basically, so they’re more a control mechanism than representative of the workforce. But as more private enterprise grows in China, Chinese workers are getting fed up with their low wages and poor working conditions, and the situation has led to a large number of spontaneous protests. The workers use social media, cell phones,

and so on to tell each other that they're going to go on strike and to describe the specific situation or event that is triggering the strike, and organize themselves outside of the formal structure into a spontaneous kind of activity that is very unpredictable. So I think in that respect there are some similarities.

NPQ: *Is the technological environment feeding some of that spontaneity between stakeholder groups?*

TK: The development of social media has certainly helped, as have the ability to communicate and the transparency that I think workers now see in organizations. When they saw Market Basket shift their CEO from Arthur T. Demoulas to co-CEOs brought in by the rival faction in the company, and saw the family seeking to get more cash out of the company, they understood that the business model was going to change, the quality of their jobs might suffer in the future, the business was likely to be sold to some outside buyer—and all that they had worked to help achieve was at risk. So, the understanding and observation of that, along with a Facebook page and other social media, facilitated the employees' taking action.

NPQ: *If one were to say we might be looking at a possible era shift here, what would it be?*

TK: Well, it's too early to tell what this means, but I do think it's going to be a wake-up call to executives, to members of boards of directors. I believe there will be conversations in boardrooms, where people will ask, "What does this mean to us? Are we being fair to the workforce?" It's going to lead to more discussion in universities and business schools, where people will be asking questions like, "What does this mean?" and "What about that business model that seems to work so well for all these different stakeholders? Are we teaching enough about that?" The answer to the last is no—and maybe it will lead to some reconsideration of what's being taught. And I do think that it's going to lead workers and trade union leaders to say, "How can we build on the momentum of this case, and how can we tap into the latent unrest and frustrations that it seems to reflect?" So if

this is the beginning of something new or something different, then I think it will take a variety of different forms, because we're not going to see this particular type of protest replicated in large numbers. But I do think it will lead to more coalitions between workers and customers and community members using social media and using an issue that the broad coalition can relate to and see as compatible with their own sense of fairness. That, I think, is what might happen here, and we'll just have to wait and see.

NPQ: *The Metropolitan Opera was negotiating with fifteen or sixteen different unions, and there was a lockout threat, among other issues. But in the final agreement, which has not yet been ratified between the major unions and the Met, one of the clauses requires that there be an independent financial monitor and that both sides get financial information to work with. Is that unusual?*

TK: It's not unusual for good employers to share financial data with workers—and with unions, for that matter, especially around negotiations; but to build that into the agreement and to have an independent or mutually acceptable set of experts provide that information is unusual. I've seen good labor-management relations, where the information is shared, and that really helps to build some trust. And then in negotiations, teams of union and management people will often work with a set of experts they choose jointly to study a particular issue—maybe a complicated issue around pensions or healthcare or profit sharing or whatever. So what the Met and the unions are doing is, I think, unique. But again, I think it's a reflection of the transparent world we're in now. People understand. People are smart about business. They've learned about how the strategies in marketing and other financial activities and efforts of the firm relate to the jobs and welfare of the workforce, and they just want to make sure that management is being held accountable for managing in a fair way.

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"I do think it's going to be a wake-up call to executives, to members of boards of directors. I believe there will be conversations in boardrooms, where people will ask, 'What does this mean to us? Are we being fair to the workforce?'"

Nonprofit Health Co-ops:

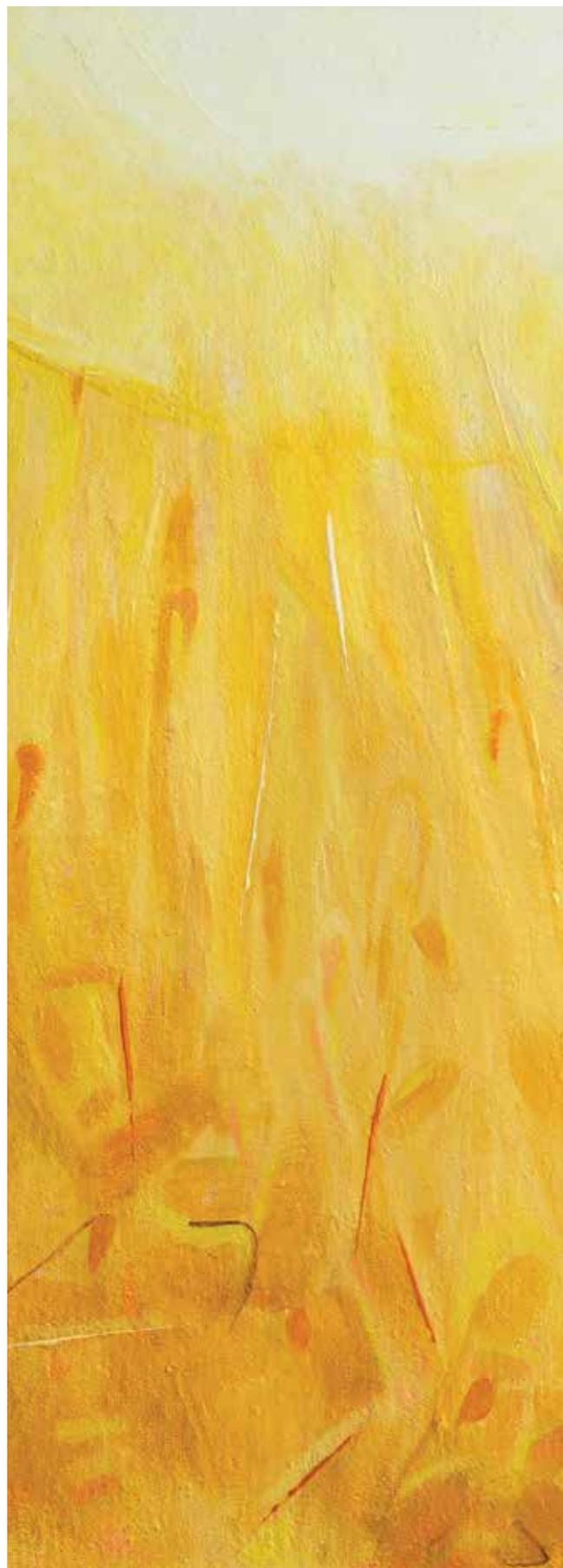
Designed to Compete for the Public Good

by Rick Cohen

Although shackled by the competition of large, well-established insurance companies, the unexpected provision for early renewal of policies not in accordance with ACA standards, and the prohibition on using federal funds for the purpose of marketing, nonprofit health co-ops are doing surprisingly well.

IT DIDN'T EXIST UNTIL A FEW YEARS AGO, BUT THE consumer-owned nonprofit health insurer Kentucky Health Cooperative sold as much as 75 percent of the private insurance policies purchased during the state's health exchange's first year of operations under the newly implemented Affordable Care Act (ACA). (Massive commercial provider Anthem Blue Cross and Blue Shield sold just 12 percent of its policies on the exchange.)¹ Nonprofit cooperatives reporting robust sales also include Maine Community Health Options and New Mexico Health Connections. Others did not fare so well. But, launched to compete with such mammoth insurance companies as UnitedHealthcare, WellPoint, Humana, Aetna, Cigna, and the abovementioned Blue Cross and Blue

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Shield (to name just a few), what all these brand-new entities share is the David versus Goliath challenge that they represent. They are not only small and untested but also structured as consumer-owned nonprofit cooperatives—and, if that weren't enough of a competitive challenge, they inhabit a market that includes large insurers that, in many states, have in the past operated in near monopolistic fashion.²

The as yet untold story is that, for all of the obvious competitive challenges facing these nonprofit start-ups, they had to overcome unexpected obstacles in the ACA federal legislation and regulations that seemed all but designed to minimize the cooperatives' chances of success. Some, like Kentucky's, succeeded—at least in ACA year one—despite those obstacles, and their strategies for overcoming them constitute a textbook of creative nonprofit approaches to competitive hurdles.

The roots of many of the obstacles experienced by the health insurance cooperatives lie in the tortured history of the Affordable Care Act and the efforts of opponents of the ACA to make a complex overhaul of health insurance next to impossible to implement. The story of the quick rise of some of the cooperatives, as participants in the rollout of the Affordable Care Act that contributed significantly to the implementation of the new law (overcoming distinctive structural competitive impediments), deserves the attention of policy-makers and the nonprofit and philanthropic sectors alike.

Origins of Nonprofit CO-OPs in the ACA

One of the core functions of the Affordable Care Act was to create competition for the big health insurers and, through that competition, compel them to improve their services and lower their costs. The intended mechanism was the “public option”—a health-insurance plan that would have been offered by the federal government, challenging the near-monopoly insurance environments in some states by providing an alternative operated and funded by government.

Although the public option was meant to be insurance, not government-provided healthcare, the idea caused a commotion among political

conservatives. Fearing that this was the slippery slope to surreptitiously transforming the American healthcare system into something more like the UK's or Canada's, Republicans organized to ensure that a public option was excluded from the legislation, abetted by President Obama's lukewarm support for a government-funded insurer.

As the public option collapsed, health reform advocates in Congress scrambled to come up with some mechanism that could effectively create competition for the big insurance companies. Kent Conrad, the Democratic senator from North Dakota at the time, stepped into the breach and suggested the creation of consumer-owned health insurance cooperatives that would provide an “affordable, accountable, transparent alternative to private insurance.”³ Would nonprofit health insurance cooperatives be able to provide sufficient and effective competition for the big private insurers? Would the very limited number of existing models of reasonably successful and sustainable health insurance cooperatives (notably, the Group Health Cooperative in Seattle, established in the late 1940s, and Minnesota's HealthPartners, dating from the late 1950s) be replicable in the context of the new health insurance law?

As Consumers Union's Chuck Bell told the *Nonprofit Quarterly*, the consumer cooperatives were not meant to be “a robust substitute for the public option.”⁴ Nonetheless, in the absence of the public option, the cooperatives that emerge from the Affordable Care Act—established as the Consumer Operated and Oriented Plan (CO-OP) Program—to offer insurance on the individual and small-group markets could become the official ACA mechanism for calling out the big insurers and providing alternatives that consumers might want. In the words of Jesse Thomas, CEO of InHealth Mutual Ohio, in an interview with *NPQ*, “the CO-OPs [as they became known] were [supposed to be] *an* alternative to the public option, but we have become *the* alternative to the public option.”

The ACA's provisions for nonprofit cooperatives (Section 1322) were a tiny part of the law—taking up only six pages of the one-thousand-page (condensed version) legislation.⁵ The law

authorized the creation of nonprofit health cooperatives that could begin selling insurance in 2014. CO-OPs could apply for low-interest start-up and solvency loans—the latter to help the new entities meet state insurance reserve requirements. Previously licensed insurers or new entities that received a quarter or more of their funding from licensed insurers could not become CO-OPs and access the federal loan funds. CO-OPs were prohibited, unlike other nonprofit insurers like Blue Cross and Blue Shield, from ever converting from nonprofit to for-profit status.

For the new cooperatives willing to enter the fray and do battle against the Anthems and Humanas of the industry, those were the rules—and they could craft strategies to try to function in this arena, just like nonprofits do within the framework of any other industry governed by federal regulations, except in this case, the “long knives” and “poison pills” (as characterized by Conrad⁶) of ACA opponents served to make an onerous challenge appear next to impossible. In Congress, former Nebraska senator (and former insurance company lawyer) Ben Nelson opposed the idea of there being start-up grants, instead of (or in addition to) loans for the CO-OPs, and supported sharp restrictions on what the CO-OPs might be able to do with their loan funds and which markets they might enter. Critics of the CO-OPs deemed the loan funds “a gift, a federal handout.”⁷ The nation’s “fiscal cliff” deal in 2013 further hit the CO-OPs by halting loans to any cooperatives that hadn’t already been approved for their funding—freezing the funding for cooperatives in twenty-four states and ruling out plans that might have been in the works for cooperatives in any other states.⁸

How could the Kentucky Health Cooperative and other CO-OPs possibly function, compete, and survive—and deliver improved health insurance coverage to consumers—in this environment hostile to the Affordable Care Act, beset with numerous well-publicized problems plaguing the operation of the federal and some state health insurance exchanges, and unsupportive of new, nonprofit entrants challenging the commercial health insurers? Some did—a few even thrived—by adopting a panoply of strategies that nonprofits

use to compete against much-better-capitalized organizations. Their stories about what worked well, what perhaps worked less well, and what the future portends follow.

Coming from Different Starting Points

The diversity of the nonprofit health insurance cooperatives’ origins is remarkable. Consumers Mutual Insurance of Michigan’s CEO Dennis Litos explained that his CO-OP emerged from discussions by county health plan providers concerned about the number of uninsured and underserved consumers. Colorado HealthOP, run by Julia Hutchins, emerged from the Rocky Mountain Farmers Union, representing small family farmers and ranchers; RMFU saw the CO-OP provisions of the ACA as a program to which “they felt like they had something to offer.” According to CEO Janie Miller, the Kentucky Health Cooperative was developed by a coalition of businesses and healthcare providers. HealthyCT, reported CEO Ken Lalime, was created by two large doctors associations in Connecticut. Oregon’s came from the state’s largest Medicaid plan.

So many of the stories sound like fairly typical nonprofit start-ups, except, of course, that they were responding to the opportunity provided by a massive structural change in the financing and content of health insurance in the United States. The cooperative serving Nebraska and Iowa, CoOpportunity Health, as recounted by then COO (now CEO) Cliff Gold, started “with three of us who didn’t know each other: Dave Lyons—the common thread—former insurance commissioner for Iowa and then head of economic development [who later became the CEO of CoOpportunity but has since stepped down]; Steve Ringlee, a venture capitalist; and me, a senior executive at Wellmark Blue Cross and Blue Shield. Dave put us all together, we began talking about starting a co-op, and we decided to put in an application.”

A number of people involved in these ventures came with health insurance experience: Cynthia Jay, CMO of Health Republic Insurance of New Jersey, had been the executive director of a health literacy coalition; InHealth Mutual Ohio’s vice

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president of community relations, Jen Patterson, used to work on housing and homelessness issues at the Columbus Housing Partnership; and Kentucky's Miller, who was also the state's former insurance commissioner, had dealt with the issue of health insurance coverage "from all sides." They also came with health insurance frustrations and critiques. Miller, for instance, told *NPQ*, "I think the country is better off [as a result of the ACA]. How can we as a country ever understand our costs and quality unless you have everyone with access and coverage and then hold providers and insurers accountable?" She described the reason for joining the Kentucky Health Cooperative as a "lifelong passion for getting coverage and access for people."

Former primary care provider Martin Hickey also said that he had seen the issue from multiple perspectives. One of the founders of New Mexico Health Connections (and friend and fellow physician of Hickey's) called to ask if he wanted to "come home" and attend one of their organizing meetings. Hickey admitted to *NPQ* that initially he "wasn't sure that the concept [of a nonprofit health insurance cooperative] was going to fly [because] everyone and their mother are starting health plans now"—but in the end he did come home to join the cause, and became the organization's CEO. Like Miller, the mission drove him. "I've been a primary-care provider. I've lived on every side of the equation, and I know how the money works. It's an unregulated system of infinite demand, and it will never stop until there are incentives to purchase wisely." Hickey described New Mexico as a "perfect place" to test the idea of a new way of providing health insurance coverage to people in need.

The notion of incentivizing people to protect their health and to purchase health services wisely is consistent throughout the plans. For instance, Colorado HealthOP consumers qualify for debit cards if they follow some useful preventative health steps, and CoOpportunity Health offers hundred-dollar gift cards for customers completing online health assessments.

The Big Work-Around: Marketing

When a typical corporation seeks start-up capital, the funds are not quite as constrained as they were

in the case of the CO-OPs. Federal regulations prohibited the CO-OPs from using federal funds for the purpose of marketing. It may be difficult to imagine, but new entities without brand identities or histories of delivering insurance products were not allowed to use their federal start-up funds to market. According to Litos of Michigan's Consumers Mutual, "We had these funds for education, but we couldn't talk about products and prices. [But] the brand is the product, so how do you do this?"

In almost every instance, the cooperatives chose the route of educating consumers—not about their products, which they couldn't do, but about healthcare, health insurance, and the Affordable Care Act itself. In many cases, it was with and through partners, particularly nonprofit ones. Consumers Mutual accessed the patients being served by federally qualified health centers and developed mailings about the ins and outs of the ACA, which, according to Litos, ensured that "our name was getting out there." Many of the cooperatives turned to the tried-and-true techniques of nonprofit outreach and marketing, working with other nonprofits at the community level (in Colorado), with the federally qualified health centers and local advocacy groups, and, according to Hutchins, "anyone who was talking about healthcare, to make sure we were part of that conversation."

In other cases, the cooperatives sought non-federal money to fund their marketing. Hutchins reported that the Colorado CO-OP got marketing funds from a health foundation. New Mexico's Hickey explained, "We couldn't market a specific plan to an individual, but we borrowed \$500,000 for a pamphlet that did concept marketing. People liked the fact that we were New Mexicans—a New Mexican health plan built by New Mexicans. No one trusted the health plans but they did trust doctors, so we just informed the public that we're physician-led, we're not corporate, and the money stays in New Mexico."

Borrowing for an entirely new organization requires, on the part of the lender, an appetite for risk. Consider that the cooperatives, while armed with business plans developed by experts in the field, were operating in a policy environment of exceptional turbulence—with the Affordable Care

Act facing an unending series of congressional votes to end the program and implementation problems highlighted by the federal government's troubled rollout of the federal health exchange website. Anticipating revenues that could be pledged against loans for marketing purposes in this environment meant that lenders might have to have as much belief in the cooperatives' missions as the cooperatives themselves.

Gold of CoOpportunity described the prohibition on using government funds for marketing as the "biggest poison pill" the CO-OPs faced—not just because they couldn't guarantee revenues that could be used to pay back loans but also because government loans were their only asset. But, according to Gold, in the case of the health-care cooperative serving Nebraska and Iowa, the Iowa credit union league gave CoOpportunity money for a feasibility study followed by a \$650,000 unsecured loan for marketing and education. CEO Kevin Lewis of Maine Community Health Options was able to get a \$300,000 grant specifically for marketing from the Maine Health Access Foundation, a vote of confidence that led to a \$500,000 grant from Coastal Enterprises, a Wiscasset-based community development financial institution (CDFI) that invested in the CO-OP based on the strength of its business plan—notwithstanding its inability to use its federal moneys for repayment.

In the end, as Gold noted, the marketing prohibition "was a huge hurdle that existed between the Affordable Care Act and the cooperatives, promoted by the health insurers to keep their advantage over the cooperatives." Gold may be speaking from the perspective of a hard-pressed CO-OP trying to get off the ground, but the restriction makes no sense other than as a means of limiting what the cooperatives can do to get started. Just as they cannot use the federal money for marketing, the CO-OPs are also prohibited from using any of the federal money for lobbying—even if the lobbying were simply to make some of the regulations on cooperatives less onerous.

Going forward, while the cooperatives may not be able to do much in the way of lobbying, it would seem logical that nonprofit healthcare

advocates step up their game to promote a more rational regulatory framework for the use of government dollars by the cooperatives.

Changing the Rules of the Game Midstream

It was a thunderous, business-plan-altering shock for the cooperatives to hear President Obama's unexpected announcement that people with existing insurance plans would be allowed to keep those plans, even if the plans were not compliant with ACA standards. The cooperatives' business plans all contained the assumption that some portion of consumers with existing plans would be in the market for new insurance coverage in order to meet the ACA's requirements.

"We don't whine or bellyache about it—we determine how we pivot and turn on the dime in response to the challenges," said Thomas of InHealth Mutual Ohio. As he described it, when the administration announced that "if you like your policy, you can keep it . . . our universe literally shrank from 800,000 eligible small businesses down to 80,000." Maine's Lewis noted that many people "early renewed" at the president's announcement, taking a substantial amount of potential business "off the table." It probably doesn't need to be pointed out that the beneficiaries of the early renewals of ACA noncompliant policies were often the big insurance companies with which the cooperatives were competing.

Making midstream business-plan modifications in the critical first year of ACA operations was hardly optimal for the cooperatives. Litos noted that the early renewals of noncompliant policies "required us to move into the small-group market," but that there were pricing and other competitive issues to address. For HealthyCT, the off-exchange small-group market didn't materialize to the degree that they had hoped, perhaps due in part to the aggressiveness of existing insurers pushing for early renewals and in part because of the tendency of many people to stick to the policies they have—even if of demonstrably higher cost and lower quality than others in the marketplace.

The president's surprise pronouncement sent a mixed message that caught the CO-OPs by surprise and limited their ability to recover during the first year of the ACA. HealthyCT's Lalime said

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that the CO-OP is still “plugging away” at this end of the market. “The early renewal piece, I’m not going to whine about it,” Lalime said. “It is the marketplace.” Unfortunately, in this case it was the marketplace twisted by an early, unthinking commitment of the president’s, who then had to live up to the statement due to political pressures even though the decision was bad for consumers (with plans not in compliance with the ACA), bad for the cooperatives (unable to market to tens of thousands of potential customers), and good only for the big insurers (who got to hold on to most of that segment of the market).

Avoiding Excessive Fixed-Cost Investments

With a constantly shifting environment and threats on every front, the smarter cooperatives chose wherever possible to avoid sinking their assets into building in-house functions. Rather, they outsourced a number of activities, which meant an upfront cost savings and, given the time constraints of getting ready to sell products on the state exchanges by October of 2013, increased the speed of operations.

For some, as in Michigan, it meant working with existing networks of insurance agents that were not associated with or owned by Blue Cross and Blue Shield. In working with the agents who were looking for better products for their customers, Litos explained, they built a network of agents capable of reaching areas where the competition might not be marketing quite as much—such as, for example, in the largely rural Upper Peninsula of Michigan. Litos reported that because the agents were looking for products that would be particularly beneficial to their customers, he and his colleagues had learned from their outside brokers that the CO-OP’s plans for its extensive chronic disease program would be a “game changer” or “tipping point.” Not investing in in-house brokers and agents but instead using existing networks gave CO-OPs like Consumers Mutual access to off-exchange customers they might not have reached otherwise and to new product ideas that were not being picked up by the competition. As the CO-OPs start to edge into large-group policies—particularly as the definition of “small group” gets changed from

fifty to one hundred members—the CO-OPs are linking up with existing networks. HealthyCT, for example, linked up with The Alliance for Non-Profit Growth and Opportunity (TANGO), representing some four hundred nonprofit groups that constitute a new network of brokers and sales for the CO-OP.

Several interviewees noted that, as new entries in the marketplace, the health insurance cooperatives were not bogged down by having to maintain and operate “legacy” systems and a built-up infrastructure that wasn’t up to the market’s demand for flexibility and speed. Apologizing for sounding very “co-op-y,” Colorado’s Hutchins sees the long-term competitive need for CO-OPs like hers to be nimble and accountable. She wants consumers and members to have a “wow experience” when they are on the CO-OP’s web portal. In New Mexico, Hickey’s CO-OP has outsourced member services so that members who call get a person, not a recording, as well as the time they need to get help with any problems. For Hickey this may be a cost savings, but it is part of a CO-OP’s strategy of incorporating empathy for the consumer.

Ohio, too, “vended out” customer service, according to InHealth Mutual’s Thomas, and also recruited a network of more than 1,300 general brokers and agents to sell InHealth Mutual’s products, rather than investing in the cost of creating an in-house cadre of agents. CoOpportunity Health’s Gold said that the CO-OP outsourced its claims processing and provider oversight, and, like others, had decided to work with independent brokers and agents rather than hiring their own.

CoOpportunity Health, having its origins in Nebraska, did exceptionally well in rural Nebraska, in part because of the independent brokers’ access to rural areas—much like other cooperatives servicing rural markets, such as Michigan’s and Maine’s. And one of the untold stories of the cooperatives may be that their most significant areas of success, like their forebears among rural electric cooperatives and agricultural cooperatives, have been their reach into rural America, whose access to health provision and health insurance historically has been limited.

Odd and Sundry Competitive Challenges

The Centers for Medicare and Medicaid Services (CMS) of the Department of Health and Human Services approved two health insurance cooperatives for Oregon, the only instance of two CO-OPs in a single state: Oregon's Health CO-OP and Health Republic Insurance of Oregon—an affiliate of Health Republic Insurance of New York. Created by New York's Freelancers Union (which since 1995 has advocated for health insurance for independent workers), Health Republic Insurance of New York (which helped establish cooperative health insurers in New York, and New Jersey, as well) apparently aimed to provide insurance to Oregon's "creative class." According to Ralph Prows, CEO of Oregon's Health CO-OP, different business plans and target markets aside, the reality of the market constraints meant that the two cooperatives ended up competing head to head.

The competition was compounded by another problem: the state health insurance exchange, Cover Oregon, had, in Prows's words, "mega-failed." Oregon was one of the state exchange disasters that left consumers confused and angry. In the midst of trying to launch the exchange, the state government also attempted a complete overhaul of the structure and delivery of state Medicaid, with the result that everyone was pretty much overwhelmed by the complexity and chaos of the system. For Oregon's Health CO-OP, that meant having to switch from enrolling customers on the exchange to going off-exchange and doing direct enrollments and broker enrollments. In addition, consumers were faced with an eighty-two-page list of plans that they had to scroll through before finding one they might want to purchase. The result was a very low enrollment in the first year—not aided by the non-cooperative competitors trying to underprice the CO-OP.

Prows may be battered from how Cover Oregon did in healthcare reform in the first year of the ACA, but he doesn't seem dismayed. "I am inspired by the mission that we have, by the democratization that we have," he said, pointing to a board that has a majority of members elected by the consumers. "People are so engaged in the movement; people really want this." (Prows also

noted that the biggest private sector competitor in the state, which had enrolled the largest number of purchasers, had just spent \$40 million on rebranding a new sports arena, and that it was also asking for a 12 percent increase in the prices of its policies on the market—the implication being that this may have been causally related.)

And then there is the issue of structure. Those non-cooperative competitors are large corporate players structured as nonprofits. HealthyCT's Lalime noted that one of his cooperative's major competitors in the state (Connecticut) is Harvard Pilgrim, which is nominally a nonprofit. Many of the Blue Cross and Blue Shield entities are structured as nonprofits, too. For a nonprofit CO-OP, that means distinguishing how these large corporate players operate in the market (notwithstanding their nonprofit tax status) versus how a consumer-oriented, consumer- and provider-run cooperative operates.

Despite what often seems to have been a life-and-death political scrum over the Affordable Care Act in Congress, there was little indication that political bias was a huge competitive problem for cooperatives at the state level. New Jersey, however, did not have a state exchange, and there were some problems. Health Republic's Jay reported that the governor, Chris Christie, returned ACA education funds that the state had received back to the federal government. In addition, New Jersey didn't end up with many healthcare navigators, who played such an important role in other states in helping consumers understand how the state and federal exchanges work. The lack of those consumer guides may have helped hamper progress for New Jersey's cooperative simply because the cadre of grassroots organizations explaining and promoting the ACA wasn't quite up to snuff.

The political imbalance in New Jersey could also be seen differently. The existing insurers, some of them fifty or sixty years old, had longstanding relationships with the state insurance departments, and knew the ins and outs of what the states might look for and accept in licensing applications. For the new CO-OPs (except perhaps those like Kentucky's, where the CEO happened to be the former state insurance

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Essentially, long-term political and business dynamics between the large insurers and the state regulators meant that frequently the CO-OPs had to deal with competitors who had better inside information than they did about the likely decisions emanating from state agencies.

commissioner), it often felt like being behind the eight ball: a second slower than the big competition in knowing what the insurance departments were going to require and decide. Essentially, long-term political and business dynamics between the large insurers and the state regulators meant that frequently the CO-OPs had to deal with competitors who had better inside information than they did about the likely decisions emanating from state agencies. For some CO-OPs, it meant delayed approvals—some almost to the start of the October 2013 beginning of the ACA sign-up period—with several cooperatives unable to offer as many different policies as their big corporate competitors.

Some of the cooperatives have, however, gone beyond the Affordable Care Act to provide services that the ACA didn't call for (and that, perhaps, it should have). If consumers have frequent problems with health insurance, they probably have similar if not worse problems with dental care coverage. The ACA only included pediatric dental care as a requirement for ACA-qualified health plans for individual and small-group plans on and off the exchanges. Although the ACA excluded dental care for adults as a mandatory component of ACA-qualified insurance plans outside of Medicaid, Maine's CO-OP, according to CEO Lewis, created a partnership with Northeast Delta Dental to put oral health coverage into its plans.

The CO-OPs' Mission and Nonprofit DNA

InHealth Mutual Ohio's Patterson made an observation about the core competitive advantage that the nonprofit CO-OPs used to their benefit in dealing with their competitive challenges. Of course, they had to deal with their positions in the health insurance marketplace from a business perspective, but InHealth Ohio, like the others, drew strength and competitive juice from their missions. Patterson explained that it was in the organization's "DNA to increase access to care." That mission commitment, superseding business concerns, turns into a competitive advantage for the CO-OPs if they remember and capitalize on it. "We kind of feel like we're in a space to ourselves," Patterson said—in part because she and

her colleagues spent much of their start-up time traveling around Ohio having conversations with communities "about what the insurance sector as a whole is missing."

Similarly, InHealth Ohio's Thomas said that the cooperative aimed to "make sure that we don't get wrapped around the axle around any one thing that takes our focus off from what our core commitment is . . . access, innovation, and competition." Barbara Freeman, InHealth Mutual Ohio's chief doctor, homed in on how their nonprofit consumer-oriented model was responding to what they were hearing from people on the ground. She pointed out that most insurance companies are narrowing their networks of providers, so InHealth Mutual is generating a "wide open network . . . [that] exceeds the requirements of what we were supposed to do." Freeman described InHealth's efforts to get supplies and products to consumers so that they could manage their health issues, including a "bronze" plan that offers two free office visits for primary health treatment and two free behavioral health visits, and noted that eliminating co-pays on a number of products for diabetes, asthma, and depression means that people covered by InHealth will never have to say, "I couldn't get my medicine because I couldn't afford it." Added Thomas, "It's listening to the public, creating incentives rather than disincentives [for effective patient management of their healthcare needs]. We are going to remove as many roadblocks as we can to critical access and improvement." Listening to the public—if the cooperatives are really listening—means responding differently in different environments.

Take Oregon's Health CO-OP, for instance. Prows reported that Oregonians directed the CO-OP to value what *they* valued in healthcare—and, to his surprise, that included support for "naturopathic" doctors and treatments. "This came up in every single session. I was compelled because of our mission to explore this." Prows, a physician himself, did not come from the naturopathic model, but upon learning that the CO-OPs were licensed to provide primary care medical treatment, he concluded, "If they're licensed by the state to do this, why wouldn't I bring them on as primary

providers?" Simply put, "They wanted providers that speak to them and promote wellness on their terms." Consequently, the CO-OP credentialed over one hundred naturopathic physicians. "My orientation has shifted from a paternalistic health plan viewpoint," Prows concluded. "Now we have to listen to what people really want rather than what we think they want."

For Prows, that also meant simplicity. As he explained, consumers complained that under other providers "they would never know what their actual expense would look like. Consumers wanted us to simplify this so that they would know their actual costs." As a result, the Oregon CO-OP "got rid of coinsurance," which Prows described as a "mystery" for consumers, so that "members know exactly what it is going to cost [and] can make logical choices knowing what their costs will have to be." The simplification of health insurance is a consistent theme running through nearly all of the CO-OPs in terms of what they heard from potential purchasers.

In Colorado, the local issue was different. "Early on, we were asked by a number of nonprofit consumer advocacy groups about covering care for transgendered persons," Hutchins recalled. "Our board took a position of nondiscrimination in healthcare. We support what's medically necessary."

For Kentucky's Miller, the competitive theory is simple: "Treat the customers as well as you can, provide value for them, and help them understand why investing in themselves is so important." That simple theory led to a little nonprofit like Kentucky Health Cooperative's capturing three-fourths of the state's market—and since then being awarded access to West Virginia, as well. "We've hit a chord there," Miller modestly observed. It's a matter, she said, of "talking about why the CO-OPs were created and what value [they] bring to the insurance industry." New Mexico's Hickey saw it from another angle. Implicitly acknowledging that most people don't like dealing with health insurance, don't like thinking about it, and get confused by the offerings, Hickey said that the New Mexico frame on the various health plans could be described as "we suck less." But, given the problem of getting

people to change plans, even if there are cost-based reasons for doing so, "the differentiator would then be service."

Hickey's strategy in New Mexico is brazen. "Our model is to disrupt the wasted volume incentives, arm the primary care providers with information about quality, and let them make the referrals—because as primaries they take better care of their patients," he explained. "We have no co-pays on patients' chronic and behavioral meds. Keeping people on their meds will reduce unnecessary hospital visits and unnecessary hospital procedures, so it's clear where the money is to be saved." He added, "Our business model is like Robin Hood's: take it from the hospitals and take it from some of the overzealous specialists and return the savings to the providers and the members."

Looking to the Future

Despite their modest expectations and, in some cases, modest results, the CO-OPs have had an outsized impact on the markets. The big providers are, of course, still ruing the competition from these relatively tiny start-ups, and suggesting that, as newcomers, their operations may not be sustainable. Our inquiries to a number of the CO-OPs' large, established competitors yielded the following statement sent in by Aetna spokesperson Cynthia Michener, who elected not to be interviewed:

A robust, competitive health care marketplace operating on a level playing field is necessary to assure that consumers receive improved quality, lowered costs, and the best value. New players like co-ops can be part of a fair and vibrant marketplace. However, it is critical for consumer protection and market stability that regulators take care that the special financial terms and assistance the ACA awarded to co-ops do not inadvertently lead to solvency vulnerabilities or to distorted pricing.

Nothing in the statement is inaccurate at face value, but it doesn't address the restrictions placed on the nonprofit health insurance cooperatives that made the marketplace in which they operated feel less than "fair and vibrant." Moreover, there is little question that while the CO-OPs tried to wring every

Despite their modest expectations and, in some cases, modest results, the CO-OPs have had an outsized impact on the markets. The big providers are, of course, still ruing the competition from these relatively tiny start-ups. . . .

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last dollar of cost out of the pricing that was offered to consumers, in several instances they found themselves facing distorted pricing practices from the large insurers themselves.

But there is no question that in many states the CO-OPs—to the advantage of the consumer but in some ways to the disadvantage of their own competitiveness—have had an impact on their competitors’ behavior. The reality is that the big providers saw the pricing and products being offered by the cooperatives and in many cases adjusted theirs downward, sometimes to levels of “predatory pricing,” as described by New Mexico’s Hickey—causing the state insurance commissioner to question their actuarial soundness and require all of the competitors on the state exchange to resubmit their plans and prices. Some state insurance commissioners, regardless of political party, were on the job in watching the pricing and products that were being offered—and, in fact, the interviewees from the cooperatives had generally positive things to say about the state insurance commissioners. Nevertheless, predatory pricing does seem to have seeped in and undercut the ability of some cooperatives to offer competitive rates.

If the role of the CO-OPs was to offer not just competitive pricing but also competitive quality in order to compel the large insurers to change, that happened too. Television advertisements by the likes of Humana abound, touting the simplicity and clarity of their offerings or promising consumers that they will not have to wait on hold for an eternity to speak over the phone with insurance company representatives. The large insurers are more than aware of commitments like the Health Republic of New Jersey’s, which, according to Jay, reports that a customer’s “call wait time is only fifteen seconds, 90 percent of problems [are] resolved on the first call, [and] the average time of the call is around five to six minutes.” Responsiveness to the customer becomes a competitive yardstick that the large insurers must try to meet—as they should—else they become even more unpopular with consumers than they already are.

In the end, all the cooperatives contacted by NPQ—those with strong performances as well as those that teetered in the first year—saw themselves as part of a grand effort to produce a

change in American healthcare that hasn’t been seen since the advent of Medicaid and Medicare, in 1965. As New Mexico’s Hickey said, “I am very grateful to the taxpayers for funding this experiment if it can inch us that much closer to a rational healthcare system.” The results of this experiment may well have surprised the White House, which was less than enthusiastic about the public option and not particularly assiduous in its support of the nonprofit health insurance cooperatives. Hickey believes that the administration didn’t expect to receive more than a handful of CO-OP applications at the outset, having agreed to the CO-OPs simply in order to placate the public option advocates, and was probably surprised by the more than two dozen that arrived in the first wave.

For all of the chaos and turbulence of the rollout of the Affordable Care Act—plus all of the obstacles that made the first year’s operations of the nonprofit cooperatives that much more difficult to pursue—the interviewees basically chose to follow the path of InHealth Mutual Ohio’s Freeman. “I’m not going to sit here and bad-mouth the Affordable Care Act,” Freeman declared—a position she acknowledges that her political party (Republican) tends not to support. “In my heart, I know that we have an underserved population . . . a population that could not get insurance because of adverse selection,” she explained. “The Affordable Care Act affords an opportunity for access to care . . . [and] the cooperatives were given a commission that allows them to create a competitive market for insurance companies and, most of all, to improve the quality of care that is provided.” Her summation is a powerful statement on behalf of the CO-OPs overall:

Our approach is not to focus on the barriers in the Affordable Care Act that give us problems, but to focus on solutions. You don’t do off-the-shelf products and off-the-shelf filings, but you create something specific to the needs of a defined population and make it specific to the individual. You take the cases one by one and deal with the barriers that the individuals have. You partner with the community, and you don’t drop the ball.

Thinking back to when she was in practice with her father and nicknamed “Little Doc,” Freeman

concluded, “Let’s get back to what medicine used to be.”

Health Republic Insurance of New Jersey’s CEO Jim Martin seemed moved by a telephone conference call for the CO-OPs in September of 2013, right before the opening of the ACA marketplace, arranged by CMS. Martin described how, on the call, President Obama “made reference to the fact that . . . this was clearly an historic moment and an historic time.” In that light, an evaluation of the cost reductions, improved care, and innovation that the CO-OPs are supposed to bring to the health insurance marketplace won’t be anytime soon. The year 2017 was most often quoted by the cooperatives as the right time to assess whether the cooperatives have been successful. As Martin concluded, “It’s a marathon, not a sprint.”



Nonprofits may want to look at how the nonprofit health insurance cooperatives addressed and overcame the competitive obstacles confronting them, and reaffirm the competitive prowess that is in their missions and nonprofit DNA. If nonprofits go back to what nonprofits used to be—connected to communities, committed to serving people in need, and highlighting those distinctive roles and functions—they may discover that they can overcome many of the hurdles placed in their way by the corporate sector and governmental entities overly influenced by corporate lobbyists. By combining the services they deliver—for instance, to families and communities that are marginalized and mishandled by corporations in their commodification of social goods—nonprofits could deliver superior products and, by virtue of their track records, advocate for improved public policies that will redress inequities like the problems of health insurance coverage in the United States.

Hutchins concluded her interview with *NPQ* with the statement, “The CO-OPs are much more willing to bet on the success of healthcare reform [than are the large insurers with which they are competing],” many of which were reluctant about the national health insurance reform at best. Indeed, believing in the Affordable Care Act and wanting to see it succeed may very well turn out

to be the nonprofit health insurance cooperatives’ ultimate competitive tool.

NOTES

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Is This as Good as It Gets?

The False Promise of Risk-Based Medicare and For-Profit Dominance of Care

by William D. Cabin, PhD, JD, MPH, MSW

Up until 1980, home-health agencies were excluded from receiving Medicare funding. Since the reversal of the prohibition and later institution of a risk-based managed-care model, there has been a surge of for-profits into the home-health/nursing-home/hospice field. Proponents of the managed-care model promised increased quality and decreased cost—but research is showing that the very opposite is true.

UNIL 1980, FOR-PROFIT HOME-HEALTH AGENCIES were not allowed to receive Medicare funding. For-profits were originally excluded because home health was viewed as originating from a voluntary and public health-sector environment. By 1980, the

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free-market model in health insurance had shifted significantly—to a managed-care model building on the work of Dr. Paul Ellwood and the beginnings of the Medicare managed-care benefit. In 2000, a risk-based managed-care model of reimbursement was instituted. Since then, the growth of for-profits among nursing homes, hospices, and home health-care has been nothing short of explosive. A number of pieces of research indicate that for-profits in these fields tend to create increased costs for the taxpayer and provide a reduced quality of care.



[T]he Medicare risk-based models have been accompanied by a rapid, significant dominance of for-profit providers—particularly among Medicare’s two largest post-acute care providers, home health and hospice—a result of which has been significant cost increases. . . .

Evidence of the risk-based model’s failure to meet the promise of managed-care pioneers to simultaneously increase quality and decrease costs for Medicare patients, compared to the Medicare fee-for-service (FFS) model, has been mounting for years.¹ In a separate though related development, the Medicare risk-based models have been accompanied by a rapid, significant dominance of for-profit providers—particularly among Medicare’s two largest post-acute care providers, home health and hospice—a result of which has been significant cost increases, with for-profit profit margins significantly exceeding those of nonprofits. A second result has been data raising significant questions as to whether for-profit-managed post-acute care providers deliver quality care at least equal to that delivered by nonprofits, with new data in Medicare home health indicating that for-profits provide lower-quality care at higher costs while garnering higher profit margins.²

This article examines the evidence Congress has ignored both at the broad level and—more specifically—at the level of home health and hospice, and the implications as we enter the Affordable Care Act era.

The False Promise of Market-Based, Medicare Managed Care

Dr. Ellwood and other managed-care pioneers asserted, beginning in the 1960s, that the managed-care model used by commercial health insurers was successful in reducing costs and increasing quality of care, and should be adopted by Medicare.³ However, the commercial populations, unlike Medicare, catered to young, middle-class or higher-income-level single adults and families with children, all with limited health risks.⁴ But others criticized the use of managed care and privatization in health-care as ultimately more costly and less focused on patient care than the publicly operated programs, which are without profit incentives and are not privately owned.⁵

Nevertheless, in 1973 Congress began phasing in what is now called “Medicare Part C,” or “Medicare Advantage,” believing it would decrease Medicare costs.⁶ Medicare Part C enrollment

has been increasing steadily from 6.9 percent in 1999 to approximately 15.7 percent of all Medicare beneficiaries in 2014.⁷ However, the Part C plans have been found to cost approximately 10 percent more per Medicare beneficiary compared to Medicare FFS programs.⁸ A recent National Bureau of Economic Research study indicates that the Medicare program has attempted to limit the increasing costs of Medicare Part C providers via changes to the risk factors included in the risk-based reimbursement formula.⁹ The Part C providers mastered the adjusted formulas to maintain or increase profits. The Center for Public Integrity has presented evidence of Medicare Part C providers’ questionable billing practices, including questionable coding decisions to maximize reimbursement under the risk-based formula.¹⁰ Another study has examined the quality of outcomes in Medicare Part C compared to Medicare FFS beneficiaries and concluded that the issue has not been well studied but that what study there is shows some limited, preliminary evidence that Medicare Part C may be less costly, depending on the methodology used.¹¹

In addition to literature on the Medicare Part C program, there is substantial literature generally on for-profit quality-of-care performance and costs compared to that of nonprofits. The literature is particularly relevant to examination of post-acute care providers where for-profit care provision using risk-based models dominates. Studies of hospitals, health maintenance organizations, nursing homes, hospices, and dialysis providers have found that investor ownership is associated with lower quality and, where hospitals are concerned, higher costs.¹² In fact, after comparing performance differences—cost/efficiency, quality, access, amount of charity care, etc.—between private for-profit and private nonprofit U.S. healthcare providers, based on 149 studies of multiple relevant databases since 1980, Pauline V. Rosenau and Stephen H. Linder asserted, “Caution is warranted on policies that encourage private for-profit entities to replace private nonprofit providers of health care services in the United States.”¹³

Medicare Home Health

The Medicare home health prospective payment system (PPS) took effect in October of 2000, instituting a managed-care risk-based model using home health resource groups (HHRGs). The HHRGs were based on twenty-plus elements from a national home health assessment instrument, Outcome and Assessment Information Set (OASIS), to reimburse for sixty-day episodes.¹⁴ Much like the earlier diagnosis-related groups (DRGs) for Medicare inpatient care, the provider took the risk per episode for costs being above or below the reimbursement rate, creating the potential for profit or loss. Home health agencies began using OASIS in 1999. Beginning in 2003, the Centers for Medicare and Medicaid Services used multiple OASIS-based elements to create a nationally mandated set of quality indicators in the publicly available Home Health Compare (HHC) database and website.¹⁵ The number of OASIS-based elements included in HHC expanded several times. Currently, HHC uses twenty-three elements for quality scoring. The data is updated quarterly, reflecting the prior twelve months. Consumers are encouraged to comparison shop HHC in their geographic area by reviewing agencies' quality scores when selecting a provider.

But Medicare home health expenditures have risen sharply since the inception of Medicare's risk-based prospective payment system (PPS): from \$8.5 billion in 2000 to \$18 billion in 2012—a 113 percent increase.¹⁶ And home health is a major driver of geographic variation in Medicare service utilization.¹⁷

Investor ownership of home health agencies has grown rapidly, with for-profits accounting for 62 percent of all agencies in 2010.¹⁸ The growth is significant—especially since historically, nonprofits and government agencies dominated home health, and for-profits were prohibited from owning Medicare-certified home health agencies until 1980. Medicare home health agencies have garnered significant profits under PPS, averaging 19.4 percent of revenues across all agencies in 2010—the second highest profit rate among all Medicare provider types.¹⁹ Proprietary agencies' average annual profit

margin, 20.7 percent, is about 35 percent higher than the nonprofit average.²⁰

A 2011 investigation by the Senate Finance Committee suggested that some proprietary agencies may have gamed PPS to increase profitability, possibly employing fraudulent means.²¹ The Affordable Care Act of 2010 expanded Medicare's authority to stop payment for suspect or fraudulent home health services.²²

In the aforementioned study I coauthored in 2014, my colleagues and I analyzed national cost and case-mix-adjusted quality outcomes from 2011 from over seven thousand Medicare-certified home health agencies to assess the performance of for-profit and nonprofit agencies. The data came from Medicare cost reports merged with data from Medicare's HHC quality outcomes database. Proprietary agencies scored slightly—but significantly—worse on overall quality and on three of the four quality subcategories, including patient hospitalization (28.4 percent versus 26.5 percent at nonprofit agencies). Quality measures were lowest in the South, where for-profits predominate. Proprietary agencies also had higher costs per patient (\$4,827 versus \$4,075 at nonprofits), were more profitable, and had higher administrative costs. Our findings raise further concern about Medicare's increasing reliance on for-profit agencies and the efficiency of its market-oriented, risk-based home care payment system.²³

Further concern for home health quality performance exists in data from the Medicare Payment Advisory Commission (MedPAC). MedPAC has looked at average home health quality and found “quality measures appear to be steady for home health care on most measures.”²⁴ However, steady is not impressive. Home health performance has not displayed significant increases on most functional measures since 2007, and has not improved on the two adverse event measures (emergent care use and hospitalization) since 2004. MedPAC reported in 2014 that quality “measures either held steady or improved slightly [by 1–2 percent] in 2012 and 2013.”²⁵

One older MedPAC analysis from 2004 to 2011 found a few significant percentage

A 2011 investigation by the Senate Finance Committee suggested that some proprietary agencies may have gamed PPS to increase profitability, possibly employing fraudulent means.

Investor ownership of home health agencies has grown rapidly, with for-profits more than tripling their growth between 2000 and 2011, resulting in for-profits accounting for 57 percent of all Medicare hospices in 2011 compared to 30 percent in 2000.

increases for improvements in functional measures: walking (36 percent to 55 percent); transferring (50 percent to 53 percent); bathing (59 percent to 64 percent); medication management (37 percent to 46 percent); and pain management (59 percent to 66 percent). In another MedPAC analysis, emergent care use (where a lower score is better) was 21 percent in 2004 and 22 percent in 2010, and relatively stable each year in between. Hospitalization (how often home health patients had to be admitted to the hospital, also where a lower score is better) was similar, at 28 percent in 2004 and 29 percent in 2010, and also relatively stable in between.²⁶ The hospitalization rate is important because of the high Medicare costs of rehospitalizations and Medicare's efforts to control such costs.²⁷

The Hospice Medicare Benefit

The Hospice Medicare Benefit (HMB) was legislated in 1982, creating a risk-based model with four levels of care, each with a fixed per diem rate regardless of utilization per day.²⁸ The legislative goal was to simultaneously reduce Medicare end-of-life costs, primarily attributable to inpatient hospital stays, and improve patient end-of-life quality.²⁹ Unlike Medicare home health agencies, hospitals, and nursing homes, Medicare has not created a standardized, national, publicly available quality outcomes database for Medicare hospices, thus limiting research on comparative quality-outcome effectiveness of Medicare hospices.

Medicare hospice expenditures have risen sharply since HMB's inception, from \$205 million in 1989 to \$13.8 billion in 2011. Investor ownership of home health agencies has grown rapidly, with for-profits more than tripling their growth between 2000 and 2011, resulting in for-profits accounting for 57 percent of all Medicare hospices in 2011 compared to 30 percent in 2000.³⁰ This represents a significant shift in hospice ownership, which was dominated by nonprofits pre-HMB and in the early years of HMB. In 1995, for example, nonprofits represented 72 percent of all Medicare-certified hospices, compared to 43 percent in 2011. Medicare

hospices have garnered significant profits, averaging 7.5 percent of revenues across all agencies in 2010. However, proprietary agencies' average annual profit margins far exceed nonprofits, with for-profits' 2010 average profit margin at 12.4 percent, compared to 3.2 percent for nonprofits.³¹ At the same time, there is some evidence that for-profit hospices are more costly than nonprofits. In 2010, for example, the average cost of a Medicare hospice beneficiary who died while in hospice was \$13,130, compared to \$10,990 for those in a nonprofit—a \$2,140 per beneficiary, or 15 percent, difference.³²

Some studies indicate that the HMB may significantly reduce government expenditures³³ and improve quality of life.³⁴ There is also evidence that enhanced home-based hospice programs may save private insurers costs and improve patient and caregiver outcomes.³⁵ However, other studies, albeit limited, indicate that there may be a significant difference in the quality performance of the more costly, high-profit-margin for-profit Medicare hospices compared to nonprofits: Melissa D. A. Carlson, William T. Gallo, and Elizabeth H. Bradley used an organized logistics models method on a sample of 422 hospices nationwide, finding that patients in for-profits received “a significantly narrower range of services . . . than patients of non-profit hospices”—raising concerns about “the potential impact of profit status on the care their patients receive”,³⁶ Richard C. Lindrooth and Burton A. Weisbrod quantitatively analyzed national HMB admissions data, finding that “for-profit hospices are significantly less likely to admit patients with shorter, less profitable expected lengths of stay”,³⁷ and, while not specifically addressing quality, Melissa W. Wachterman, Edward R. Marcantonio, Roger B. Davis, and Ellen P. McCarty, in a study of 4,705 patients discharged from hospice, concluded, “Compared with nonprofit hospice agencies, for-profit hospice agencies had a higher percentage of patients with diagnoses associated with lower-skilled needs and longer lengths of stay”—further raising questions about for-profit higher costs while targeting patients with low-skilled needs.³⁸

Policy Implications

The evidence seems overwhelming that managed-care Medicare should not be as good as it gets for Medicare beneficiaries and taxpayers. There seems to be more than a reasonable amount of data supporting the adverse economic and patient-care effects of maintaining the current for-profit risk-based system—at least insofar as concern Medicare home health and hospice care. The data from these two programs should also prompt concern for other Medicare provider types displaying similar patterns, such as Medicare nursing homes. Medicare imposed a managed-care model on nursing homes in July 1998. Currently, 70 percent of Medicare nursing homes are for-profit, with a 2012 profit margin of 16.1 percent, compared to 5.4 percent for non-profits.³⁹ There should also be concern for the Medicaid program, which had over 74 percent of its enrollees in managed-care plans as of 2011, and is the focus of expansion under the Affordable Care Act.⁴⁰

Is such data not sufficient to prompt Congress to review the current models? A great deal of time and energy has been and continues to be spent on hearings and legislative challenges to the Affordable Care Act. Much of this activity is based on tenuous projections about economic impact. In the meantime, the Medicare program, often criticized by Congress for cost concerns, seems headed in the wrong direction, with Congress paying no attention to evidence that seriously challenges the worthiness of the risk-based models and for-profit dominance.

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Competitive Positioning:

Why Knowing Your Competition Is Essential to Social Impact Success

by Peter Frumkin and Suzi Sosa

As the authors explain, “Competitive analysis is an essential tool . . . for leaders seeking to position a new innovation and/or organization” and for “established organizations to continually orient themselves.” This article lays out the steps to building, positioning, and growing in the changeable landscape of social innovation.

ENTREPRENEURSHIP IS ROOTED IN THE ENTREPRENEUR’S identifying, seizing, and aggressively taking advantage of an opportunity—and innovation is often at the core of this response. The opportunities for social innovation are abundant and the range is vast: even in market sectors in which there are many established providers, social impact leaders are often able to uncover previously unimagined opportunities and

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Providers within a defined market may be formally competitive or they may see themselves as more collaborative. However, in most cases, even in markets of exclusively nonprofit organizations, the providers within a single market compete for donor support and client fees.

Organizations sharing a single market may compete for two key resources . . .

Donors

There is considerable competition for support from foundations, corporations, and individual donors, with many organizations vying for grants. Investing in fundraising capacity and talent is seen as a strategic response to the struggle for donations, and for salaries for proven development professionals to continue to rise. Still, competition for funding is driven by an odd combination of performance, reputation, and personal relationships. Because funding decisions are often opaque and market signals unclear, managing competitive pressures in the funding domain is especially challenging.

Clients

Where many organizations are concerned, there are always people who can benefit from their services—especially when they are provided for free. When fees are charged, the pool of clients often narrows and the competition for earned income heats up. The competitive pressure for clients has turned marketing from something deemed slightly too business-oriented into expected practice. Without effective outreach to clients, many organizations would be unable to secure the customers they need to both achieve their mission *and* balance the books.

disrupt long-standing equilibriums—whether with a new product or service, or with an adaptation of an existing product or service (via identification of, for example, a new geography, customer, or delivery mechanism). And for social impact leaders assessing the quantity and quality of opportunities, the first step is to understand the market in which they wish to innovate.

The Market

All organizations, even nonprofits, operate in the context of markets. At the highest level, a “market” is the summation of the various providers offering the same product or service, usually within a finite set bound by a specific customer or geography. For example, the after-school elementary education market for a particular city would comprise all the organizations providing after-school services to elementary school children. However, organizations operate simultaneously in different layers of markets, and the resulting list of providers that will share that space is directly determined by the defining criteria of the market. Thus, providers in the after-school elementary education market might be further segmented into smaller markets by limiting the geography, the organizational type

(faith-based, public, private, nonprofit), or the specific services offered. Each of these filters will yield a slightly different solution set in which an organization can assess both its competitive advantage and its ability to maximize the opportunity for innovation.

Providers within a defined market may be formally competitive or may see themselves as more collaborative. However, in most cases, even in markets of exclusively nonprofit organizations, the providers within a single market compete for donor support and client fees. For example, nonprofit programs providing adult literacy training in a particular city make up the adult literacy market. These organizations compete, at the very least, for limited funding, and also to some extent for clients and access to other resources. While the desire to put other organizations out of business may not drive the competition within this market, the other organizations nonetheless constitute the competitive landscape.

Finally, in some cases a nonprofit may be working in a space that has a significant cap on its resource pool. Understanding the limitations and potential expandability of that pool is an important factor in understanding one’s potential placement in a market.

Benefits of Competitive Analysis

Competitive analysis is a tool that social impact leaders can use repeatedly throughout the life of an organization. In the start-up phase, competitive analysis is fundamental for assessing the quality of an innovation and the risk inherent in its pursuit. As the organization grows, accurate competitive analysis provides dynamic feedback about strengths, weaknesses, opportunities, and threats, thereby guiding the formulation of strategy and providing insight into how and where social impact leaders should focus limited resources.

Many popular tools are available for competitive analysis at various stages in an organization's growth, depending on the question the entrepreneur seeks to answer. Among the more well known are SWOT, the six forces model, and Michael Porter's four corners model. Each tool provides a specific lens through which a social impact leader can critically assess the organization, its position relative to competition, and its opportunities for innovation and growth. But our goal here is not to provide a comprehensive diagnostic tool kit for all types of competitive analysis. Rather, we show how one simple but useful tool enables social leaders to conduct a quick, robust, and insightful analysis of opportunity and competition, and from there to maximize social innovation and impact.

Start-Up

As social impact leaders attempt to home in on a perceived opportunity and articulate an innovation with potential for meaningful impact, the process of competitive analysis provides essential feedback on both the quality of the innovation and the risk involved in its pursuit. At the most basic level, the competitive analysis functions as an inventory of other organizations providing the same or similar products or services, and often immediately signals the magnitude of the proposed innovation. More-detailed competitive analysis enables the leader to highlight specific competitors and illustrate what differentiates his or her organization. Clear and accurate understanding of the landscape is essential for creating a powerful organizational strategy.

Unfortunately, when compared with traditional private sector competitive analysis, competitive analysis for the social impact leader can often be more challenging. First, many problems of interest to leaders are partially addressed by multiple markets. Clean water in the developing world, for example, can be provided by drilling new wells, or via filtration systems, or through the sale of bottled water. Second, within those markets, products and services may be provided by many different types of organizations, including for-profits, nonprofits, and/or hybrid organizations. This heterogeneity can make it particularly difficult to accurately map the market. For example, an affordable housing market might include public-, nonprofit-, and private-sector providers. And the array of solutions might include low-priced renovated townhomes, small rental apartments, or shelters.

Why is it important for leaders to correctly identify the market or competitive landscape in which they will operate? First, through this exercise they can orient themselves and assess where their ideas and organizations fit relative to other providers in the space. Second, they can gain critical insight into the risks associated with pursuing an innovation or opportunity. For example, at one end of the spectrum, the social impact leader may find that there are no other organizations currently operating in the market. This strongly signals high risk. On the other hand, entering a market saturated with similar providers is also a high-risk situation. Concentrating on the traits of immediate competitors forces the social impact leader to focus intently on the response to one question: *what positively differentiates my idea and/or my organization?* All viable, successful, impactful organizations must differentiate themselves on at least one criterion, and to be truly innovative, they will likely differentiate on many more.

Ongoing

Competitive analysis is an essential tool not just for leaders seeking to position a new innovation and/or organization within the context of existing providers but also for established organizations to continually orient themselves in a changeable

As social impact leaders attempt to home in on a perceived opportunity and articulate an innovation with potential for meaningful impact, the process of competitive analysis provides essential feedback on both the quality of the innovation and the risk involved in its pursuit.

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landscape. All of the aspects of a competitive landscape are continually in flux: organizations evolve internally, developing both core strengths and weaknesses; conditions change externally, yielding substantial opportunities and threats. As a result, to stay competitive organizations must conduct ongoing, dynamic assessments of these conditions and, through those evaluations, test ideas about future growth.

Collaboration

Competitive analysis can also reveal possible opportunities for collaboration. Some organizations may appear to be competitors on the surface but, upon further investigation, turn into potential partners, assuming there are significant differences in terms of the population served, the program services offered, or the geography covered. In the nonprofit sector, given the immensity of social problems and the long list of potential clients, uncovering potential collaborations and fruitful partnerships can be helpful.

While our focus here is on competitive positioning, we do not want to foreclose the possibility of substituting collaboration for competition when collaboration is both possible and advantageous. Indeed, collaboration can turn out to be an organization's competitive advantage, and how the partnerships are used, its innovation. Opportunities for collaboration generally depend on some overlap in organizational mission and focus, and knowing what others offer can thus be a first step in mapping both competitors and potential collaborators. Collaborations can be difficult to define and manage, however, and sometimes a competitive lens is the appropriate one, even if this proves culturally challenging to nonprofit leaders.

Next, we offer systematic advice for understanding and managing competition.

Determining the Market

Preliminary Mapping

All social impact leaders should build a comprehensive map of the overarching competitive landscape. This rapid exercise should yield a picture of many relatively diverse organizations. The benefit of developing the map is to establish a rough boundary for the market in which the organization will

operate. At this level, the market may be quite heterogeneous, with limited overlap among the organization's geography, customer, and/or products; however, the exercise is particularly useful for quick observation of industry trends and, with limited effort, can shed light on the positioning of any organization—whether new or old.

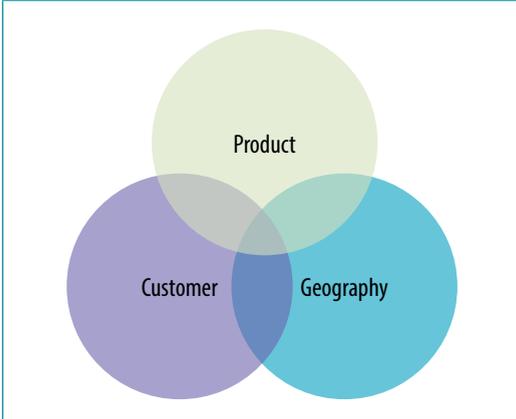
When constructing a broad competitive landscape, the most important differentiating criterion to consider is the product or service the organization provides. Ask yourself, "Who else is providing the same product or service?" Sometimes the answer is "dozens of organizations spread over diverse geographies." In that case, the leader should apply other relevant filters, such as customer and/or geography, to improve the focus. In other situations, when the product or service is very new, only a handful of other organizations worldwide may be offering the same thing. In this case, additional filters limit the solution set too much and therefore should be temporarily ignored.

When the set yielded by the first question is very large, the next two important filters are customer and geography. Specifically: Who is providing the same product or service to the same customer (but potentially in different geographies)? Who is providing the same product or service in the same place (but potentially to different customers)? And who is providing the same product or service to the same people in the same place?

The goal of this filtering exercise should be to map between ten and twenty organizations that have as many as possible of these three criteria in common. The results of the inquiry would show, in a Venn diagram, as the organizations occupying the center, overlapping space (see figure 1).

While it is important for all organizations to assess their competitive markets—and their niches within those markets—periodically, nonprofits are very often drawn to the task by a new program or innovation, or a significant perceived shift in the market. The preliminary market-mapping exercise is a useful tool at two different junctures. In the start-up phase, preliminary market mapping enables the social impact leader to rapidly assess the risk of entering a new market. In the ongoing/growth phase, preliminary market mapping

Figure 1: Venn Diagram for Preliminary Market-Mapping Exercise



allows the social impact leader to quickly glean industry trends that are useful for informing strategy and planning.

In the start-up phase, when the mapping exercise yields an empty set, meaning that there are no other organizations providing the same product or service, very high-risk conditions are indicated, because the market is either unproven or has proven so hostile that no organizations have survived. Sometimes preliminary market mapping yields a large solution set of providers already operating in the product or service space; this, too, is a high-risk scenario, because of the added pressure to convincingly differentiate the new idea and organization and to bolster the new organization against the advantages of established providers.

Whether the organization is new or established, one of the social impact leader's first assessments in reviewing the preliminary market mapping data should be an evaluation of the speed of change in the market. Is the market stable, with a relatively unchanging set of organizations? Is the market dynamic, with organizations regularly entering and/or exiting the space? Is the market turbulent, with ongoing change in the number and composition of other organizations creating significant instability? By documenting the main competitors and comparing these data over a relevant time frame, leaders can quickly determine the speed of environmental change within their markets and how that will affect their entry strategies.

A second key assessment should be a measurement of risk, based on the number of current competitors in the space. In cases where preliminary mapping yields no relevant competitors, the social impact leader should be able to articulate how he or she will respond to that particular high-risk condition. Why would a market not have any current operators? There are several potential explanations for an empty market, including: there is no perceived opportunity; unknown external forces have eliminated previous organizations attempting to harness the opportunity; the market is so turbulent that all previous providers have exited; the opportunity is so new that no other organizations have attempted to address it. An empty market should be a warning sign, and leaders should undertake extensive due diligence to uncover the reasons for the lack of other providers. It may simply be that this is the first opportunity to implement this innovation, but often an empty market signals a high risk of failure.

Preliminary market mapping may also reveal a saturated market, in which dozens of existing organizations are providing (or attempting to provide) a similar product or service. This scenario is also very risky, because evidence of a large number of stable providers means competition will be strong, and existing providers are often able to leverage to block the threat of new entrants. In this situation, the leader will have to respond to concerns about the threat of existing providers, who usually have more resources available to "steal" or replicate a promising idea.

In general, social impact leaders should look for markets where the trade-offs between risk and opportunity are balanced. Usually these markets have dynamic conditions, with a small number of diverse players who are successfully mitigating risks while taking advantage of latent opportunities (see table 1).

In general, social impact leaders should look for markets where the trade-offs between risk and opportunity are balanced. Usually these markets have dynamic conditions, with a small number of diverse players who are successfully mitigating risks while taking advantage of latent opportunities.

	Small	Medium	Large
Number of Providers	Small	Medium	Large
Opportunity	Small	Medium	Large
Environment	Turbulent	Dynamic	Stable
Danger	Low	Medium	High

The social impact leader must find a delicate balance in which the criteria selected are sufficiently informative to support meaningful analysis without contriving the results.

Preliminary market mapping allows the social impact leader to quickly assess the potential riskiness of entering a new market. It also crafts a landscape from which it is possible to observe and track high-level industry trends. However, this perspective is usually too broad to provide relevant details about the risks and opportunities a single organization faces. In order to answer these questions, most social impact leaders will carve out a subset of the broader market and focus on a smaller number of organizations that can be compared along a specially selected, more relevant set of criteria.

Detailed Market Mapping

Having constructed a broad overview of the market, the social impact leader will next want to undertake detailed mapping by applying more specialized filters to deliberately sort organizations and clearly demonstrate differentiation. Detailed market mapping engages three key questions: (1) What characteristics describe the organization but not its competitors? (2) What characteristics describe the competitors but not the organization? (3) Which of these answers matter?

From the preliminary mapping, the leader should have a list of about twenty organizations that make up the overall market. The next step is to hone that list down to a smaller subset of approximately five to seven organizations that have sufficiently relevant, similar characteristics to indicate the direct competitive landscape.

Through this exercise, the leader presents his or her niche or difference in the context of immediate competitors, and must be able to visually demonstrate how the innovation and organization stand apart from others in the same space. At the same time, the organizations must have sufficient overlapping characteristics to show that they are in the same market. The selection of these characteristics is key to clearly and persuasively demonstrating how each organization relates to the other. This information forms a snapshot—the competitive matrix of the organization.

Selecting the best criteria to define the immediate competitive landscape and construct a

competitive matrix is not a straightforward exercise. In theory, a leader could select from an almost infinite number of characteristics. On one level, the process of defining a market is highly subjective, as the leader has flexibility in selecting the defining criteria. On the other hand, incorrect selection of the criteria not only yields flawed results but also undermines the credibility of the proposition by appearing to bias the results.

In addition, the criteria selected will directly affect both the size and the composition of the resulting set. Specifically, criteria that are too broad will yield an overly large market with too many undifferentiated competitors, whereas criteria that are too narrow will yield an overly small market with too few competitors. Likewise, criteria that are too broad will not usefully distinguish the niche, while criteria that are too narrow will not set it in the context of relevant substitutes. The social impact leader must find a delicate balance in which the selected criteria are sufficiently informative to support meaningful analysis without contriving the results. In sum, the leader should select criteria that present a robust and seemingly unbiased perspective on the position of the innovation and the organization while also focusing on criteria that clearly demonstrate the strengths and differentiators.

How can a social impact leader select the best characteristics with which to construct the direct competitive landscape? To start, the leader should brainstorm a list of all of the characteristics that he or she feels distinguish the organization and the idea. These characteristics may be internal to the organization, such as the new product/service offered or the mission, or they may be external advantages, such as a key strategic relationship or access to a new geographical area (see table 2).

Most organizations tend to focus heavily on the differentiating criteria of the new product or service. However, sometimes that perspective can be too narrow and may overlook important differentiators that are independent of the new product or service. For example, what is the organization's mission? Does it differentiate itself with B Corp certification or other commitments

Table 2: Characteristics of Markets' Internal and External Differentiating Criteria for New Organizations

Internal Criteria

- Organizational Mission
- Primary Product or Service
- Product or Service Delivery (bundling, distribution channel, etc.)
- Price or Cost
- Target Customer
- Organizational Type
- Key Assets
- Growth Potential

External Criteria

- Geography
- Access to Limited Resources (key partnerships, etc.)
- Reputation
- Barriers to Entry

that set it apart from other providers in the space? Differentiation can take many forms, and a leader needs to explore them all.

Above all, the social impact leader should select characteristics that highlight the proposed innovation. For example, is the product or service entirely new or the provision of an existing product or service to a new customer? Is it a new distribution channel or a new combination of services? Is this the first time a nonprofit organization is providing the service? Is this the first time the product or service is being offered to a new target customer? Is the product or service being offered at a new, lower price?

With the initial brainstorm list done, the social impact leader should begin to sort the characteristics in order of importance. With the list honed down to no more than twenty defining characteristics, the leader should then compare those characteristics to the ten organizations identified in the preliminary market mapping and consider which of those organizations share the greatest number of characteristics with the new organization. Generally, as one applies more characteristics to the filter, the number of organizations with common characteristics can be reduced (see table 3).

Ultimately, the social impact leader should narrow the list to the top five to seven organizations with the most relevant traits in common. Sometimes this set is obvious, but other times there is more art involved in selecting the right list. For example, many leaders focus too heavily on organizations that share the same geography, when it may be more relevant to include organizations with a similar product or service in another geography.

In reality, the list of the most important differentiating characteristics is a best guess, particularly for start-up organizations, and the social impact leader will have to hone the list over time. Not only will an organization evolve and change its position in the market but also many leaders may not initially fully understand the strengths and differentiating characteristics of their own innovations. Only after launching an organization and interpreting significant feedback from the customer will the leader be able to refine

In reality, the list of the most important differentiating characteristics is a best guess, particularly for start-up organizations, and the social impact leader will have to hone the list over time.

Table 3: Characteristics Matrix

	Char. 1	Char. 2	Char. 3	Char. 4	Char. 5	Char. 6	Char. 7	Char. 8	Char. 9	Char. 10	Char. 11	Char. 12	Char. 13	# Common
Org. 1	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	13
Org. 2	✓		✓	✓		✓	✓	✓	✓		✓		✓	9
Org. 3	✓	✓	✓		✓		✓		✓	✓	✓		✓	9
Org. 4	✓		✓			✓	✓	✓	✓		✓	✓		8
Org. 5	✓		✓			✓	✓		✓	✓			✓	7
Org. 6	✓	✓		✓	✓		✓		✓		✓			7
Org. 7		✓	✓			✓			✓			✓	✓	6
Org. 8	✓		✓		✓		✓				✓	✓		6
Org. 9		✓				✓	✓			✓		✓		5

The ideal comparative analysis matrix demonstrates sufficient overlap to convincingly show that the organizations are within a similar market, while also clearly illustrating the strength and competitive advantage of the new organization.

his or her list of criteria and competitors. As a result, social impact leaders should expect to continually refine the list of criteria that distinguish their organizations as well as the list of direct competitors.

Once the leader has identified the three to five organizations and five to seven characteristics that best compare and contrast with his or her organization, the next step is to assemble that information into a useful visual snapshot—the competitive analysis matrix.

Competitive Analysis Matrix

The competitive analysis matrix is a simple tool that conveys an instant snapshot of how an organization is positioned relative to its immediate competitors. The format of the matrix is straightforward, with a list of the three to five most relevant competitors on the vertical axis and a list of the five to seven key comparative traits along the horizontal one. For each trait of the organization, a check is entered in the box, creating a view of the organization’s key distinguishing characteristics. The ideal comparative analysis matrix demonstrates sufficient overlap to convincingly show that the organizations are within a similar market while also clearly illustrating the strength and competitive advantage of the new organization (see table 4).

Table 4: Competitive Analysis Matrix

	Trait 1	Trait 2	Trait 3	Trait 4	Trait 5	Trait 6
Competitor 1	✓		✓		✓	✓
Competitor 2		✓	✓			✓
Competitor 3	✓			✓		
New Organization	✓	✓	✓	✓	✓	✓

Example: Blue Avocado

Blue Avocado is a social purpose business that launched a reusable shopping bag system targeted toward women who want to reduce their carbon footprint without sacrificing convenience or style. At the highest level, the space in which Blue Avocado was launching was the “reusable shopping bag” market; however, this framing is too broad for a relevant competitive analysis and does not usefully reflect the niche in which Blue Avocado operates. As a result, the founders opted to reframe their market with narrower criteria, selecting the following characteristics with which to compare their innovation: whether the bag was part of an integrated system; the stylishness of the product; the degrees of functionality and portability; and price. From here, the founders were able to shrink their competitive analysis to a subset of four key competitors and five distinguishing criteria (see table 5).

From this competitive analysis, we can see that, though several of the competitive products share overlapping traits with the Blue Avocado system, Blue Avocado is the only one to have all the characteristics. This convincingly shows how the product is similar to others in the market while also demonstrating what makes it different. At the same time, the inclusion of price in the assessment indicates that Blue Avocado is pricing its product substantially above that of its nearest competitor. A quick glance at Blue Avocado’s competitive matrix raises the immediate question of whether the combination of these specific traits will merit a more than 30 percent increase in price for the product. Will customers value this combination that much? By positioning their competitive analysis in this way, the Blue

Table 5: Competitive Analysis—Blue Avocado

Direct Competitors	System	High Style	Functionality	Portability	Price
EnviroSax	✓			✓	\$33
GeccoBags	✓		✓		\$24
Reisenthal		✓	✓	✓	\$12
B. HappyBags		✓			\$24
Blue Avocado	✓	✓	✓	✓	\$50

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There is no single correct competitive analysis matrix. In fact, the social impact leader may wish to construct multiple, varied competitive analysis matrices for different audiences.

Avocado founders are arguing that, yes, their price increase is justified.

In fact, after two years in the market, they discovered that the price point of \$50 was too high to achieve the scale they desired, so they introduced additional product lines at lower price points. This discovery was an important insight into their innovation, resulting in product modifications that strengthened their business and enabled them to reach more people. The risk associated with their high price point was clearly demonstrated in the competitive analysis, and fortunately, because they were aware of the potential for challenges in that area, the founders were able to respond quickly with alternative products.

There is no single correct competitive analysis matrix. In fact, the social impact leader may wish to construct multiple, varied competitive analysis matrices for different audiences. For example, one matrix may focus predominantly on the product space, illustrating how the new product is differentiated from other similar ones. Another matrix may focus on a common geography, and the compared organizations may not have much overlap on product or service but may all be serving the same or similar customers within a community.

Example: Online-Giving Start-Up

If a social impact leader wanted to enter the online-giving space with a new service called, say, GiveGreat, a competitive analysis would reveal a

crowded field, but one where a focus on impact measurement, working with young donors and seeking small gifts, might find a place. Of course, there would be some challenges to constructing the matrix, since some of the information about competitors might be proprietary and hard to obtain. But an initial mapping would still help to define the lay of the land and the possibility for a successful new entry.

Again, the choice of the key characteristics will prove critical. If GiveGreat gets this wrong, the entire exercise will be compromised. Thus, if it turns out that administrative overhead is a critical consideration for donors looking at online-giving options, omitting this characteristic from the competitive analysis will be a serious mistake and lead to false conclusions about the merits of the innovation or enterprise. Taking time to get the characteristics right may involve talking to users and doing market research before setting the terms of the competitive analysis. In this hypothetical case, the market looks primed for a youth-oriented and small-scale giving option (see table 6).

Interpreting the Competitive Matrix

The most important function of the competitive matrix is to quickly convey how the new organization fits into its market and distinguishes itself. All organizations (including nonprofits) must be able to demonstrate how they are different and better than their competition. At the same time, as described earlier, the degree of differentiation is

Table 6: Hypothetical Competitive Analysis: "GiveGreat"

Direct Competitors	Functionality/ Ease of Use	Numerous Partners	Targeting Youth	Proof of Impact	Entire donation Given to project	Average Contribution
Global Giving	✓	✓		✓		—
See Your Impact	✓	✓	✓	✓		—
Kiva	✓	✓		✓		\$500
Just Give			✓			\$15
Donors Choose	✓	✓				—
GiveGreat	✓	✓	✓	✓	✓	\$25

Competitive analysis has three primary objectives. The first is to gauge the risk associated with conditions in the current market and the likelihood of success. The second is to uncover important insights into the quality and viability of an organization's innovation(s). The third is to make use of the conclusions derived from the first two to develop an organizational strategy that maximizes impact.

also an important indicator of risk: organizations that are not clearly and convincingly differentiated are at higher risk of failure.

Social impact leaders should always use competitive analysis to inform the honing and development of their innovations. For each instance, when a direct competitor possesses a characteristic that the organization in question does not, leaders should carefully evaluate the importance of that distinction. Specifically, they should ask themselves, “Is that characteristic a strategic advantage for the other organization?” If it is not, leaders should be prepared to articulate why. If it is, leaders must begin to plan how they will address that distinction. Does the leader’s organization have other advantages that neutralize this threat or should a similar advantage be sought through either adoption or collaboration?

Similarly, social impact leaders should also be alert to instances in which all their direct competitors have a similar characteristic that their organization lacks. For example, if all of the competitors are using a similar distribution strategy for a product or service, this may indicate that this strategy is the only viable option, for pricing, regulatory, or other reasons. Leaders wishing to deploy entirely unique strategies should be sure to understand clearly why all the other competitors share a common approach and how deviating from the group may or may not be helpful. In the case of Blue Avocado, the competitive analysis underscored that its price point was significantly higher than that of other immediate competitors, and that it was deviating from the general trend of the group. It was hoping to prove that its innovation—combining the traits of a bag system with high style, functionality, and portability—was both substantial and valued enough by customers to warrant such a price increase. In the end, the analysis demonstrated that while the innovation was valued sufficiently by some customers, this was not enough on which to build a sustainable business model—so Blue Avocado quickly adapted and created new products at lower price points.

In some cases, an organization can immediately incorporate the insights gleaned from competitive analysis into the proposed product

or service. At other times, as in the case of Blue Avocado, an organization must carefully note potential risks or modifications and then activate the product or service only if the market affirms the hypothesis. Sometimes, a leader may find it difficult or impossible to adapt the innovation, even though the competitive analysis clearly demonstrates the need for it. For example, competitive analysis may clearly indicate the benefit of a key partnership or financial investment, but due to multiple potential constraints (for example, being too small, not having enough money, and so on), the leader may be unable to incorporate the new ideas into the original innovation. Here is where competitive analysis begins to inform competitive strategy: the leader must determine whether it will be most advantageous to function competitively or collaboratively with the other organizations in the competitive landscape and how to use competition and alliances as complements and substitutes to the innovation.



Competitive analysis has three primary objectives. The first is to gauge the risk associated with conditions in the current market and the likelihood of success. The second is to uncover important insights into the quality and viability of an organization’s innovation(s). The third is to make use of the conclusions derived from the first two to develop an organizational strategy that maximizes impact. Other, secondary insights are often derived from competitive analysis, including industry trends from preliminary market mapping, clear identification and articulation of the organization’s differentiation and competitive advantage, and a detailed mapping of the organization’s position relative to its immediate competition.

Social impact can no longer be pursued without knowledge of competitors and what they offer. Organizations must understand the competitive environment as a first step in building, positioning, and growing in the turbulent waters of social innovation and impact.

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Are We “Walmartizing” the Social Sector?

by Michael Lombardo

There are many reasons to scale, but organizations should think carefully about what is motivating them to do so, as there are even more reasons not to. For, as the author contends, “If done well, a scaling approach can exponentially increase an organization’s impact”; but if done poorly, it can be “a disruptive diversion of precious resources that commodifies rather than serves communities of need.”

LAST SUMMER, MY FAMILY AND I WENT ON THE Great American Road Trip, driving from our California home to the East and back again. Over six weeks, we passed through seventeen states, visited nine national parks, and, to our great pride, ate only one fast-food-chain meal the entire time. (My kids pronounced the food “spongy” and “weird.”)

It isn’t often that I think of my work running a national children’s literacy nonprofit as being connected to chain restaurants, but during my hours of driving it occurred to me that, for all my “shop local” sensibilities, I was actually doing to the education sector what Burger King and McDonald’s were doing to food.

Were my efforts over the past seven years scaling Reading Partners across sixty school districts in nine states basically creating a miniature, socially oriented version of Walmart?

What We Mean When We Talk about Scale

Like the process of scaling, defining “scale” is complicated. Frequently, scaling is used

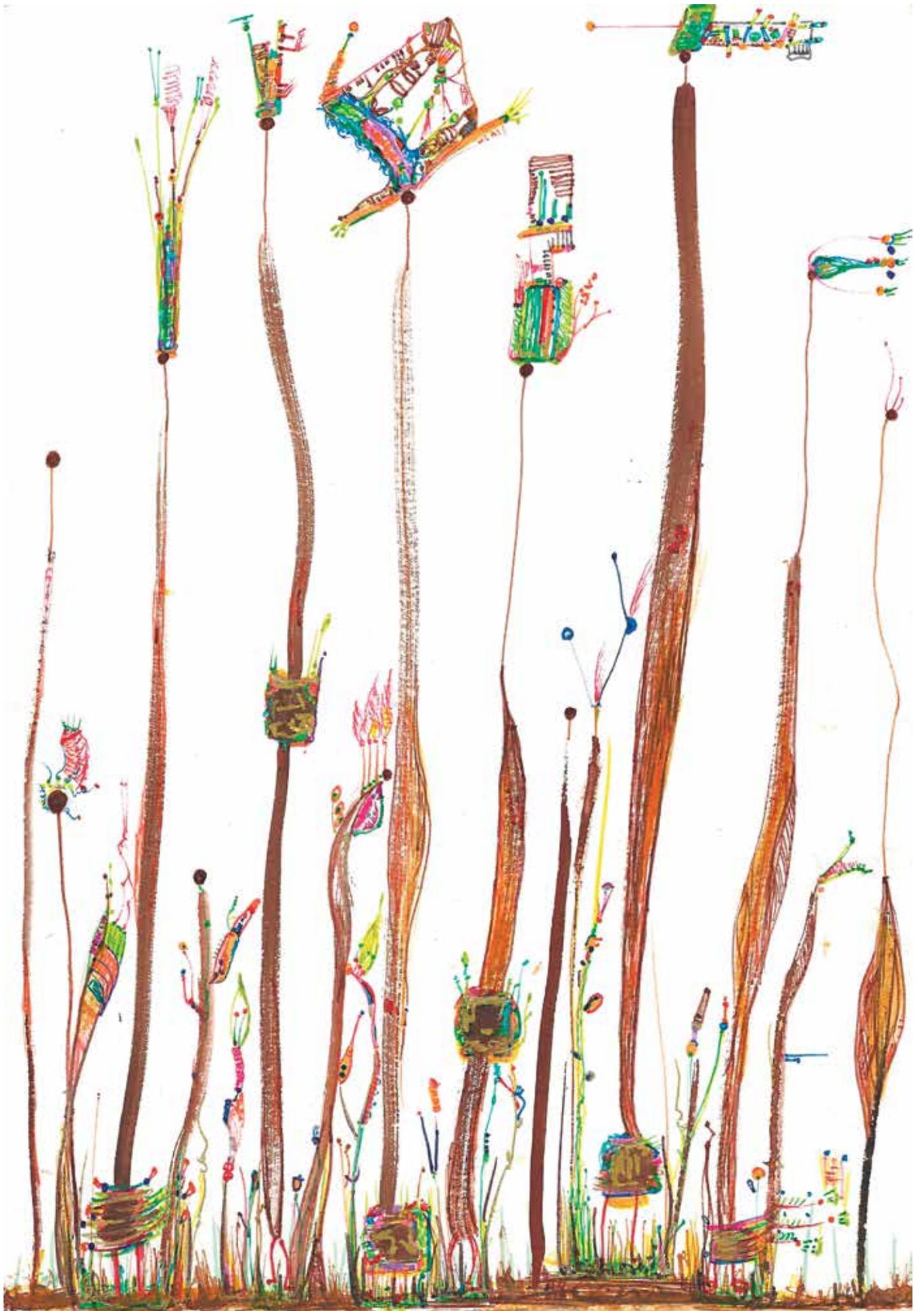
interchangeably with “growing” to describe a program or organization that is significantly expanding in size over time. “Size” is also a complex term: it can describe the number of clients served or the services provided to those clients; the operating budget; the geographic footprint; or some combination of all those factors.

When we use “scale” and “growth” as synonyms, we miss an important distinction, just as we do when we confuse “size” and “impact.” Scaling is less a structural description and more a mind-set for organizations—a focus on addressing a social problem at the neighborhood, city, state, national, or even global level. A scaling organization must think about its impact as well as its size—and hopefully more the former than the latter.

A scaling organization’s resources and strategies should be calibrated to the scope of the problem it seeks to address. An organization that serves only 1 or 2 percent of its target population is not necessarily scaled, just as an organization that seeks to address a problem affecting millions of people is not necessarily scaling if it impacts a thousand more lives each year.

Nor is scale a binary state into which organizations can easily be categorized. Just as in the for-profit sector there are some companies that are clearly scaled (Walmart), there are others that fall into a gray area, such as regional or urban-only chain operations, and companies that hold large but not dominant market share in crowded sectors.

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If scale is less a state of being and more a way of thinking about social problems, then what is it that compels nonprofit organizations to adopt it as an operating principle? Put another way, why do organizations sometimes feel compelled to grow beyond their founding communities?

Scale, therefore, is ultimately in the eye of the beholder. While we might argue about what defines a truly scaled organization, for the purposes of this essay I will consider it a self-applied label. (If an organization or its stakeholders believe it is scaling, then we should describe it as such, and that organization therefore needs to be thoughtful about its scaling activities.)

Leading Reading Partners through its efforts to scale nationally, I am the first to admit that much of what I learned about scale comes from the mistakes we made in our earliest efforts—a few of which continue to pose challenges in some of the communities we serve. In many cases, my knowledge about scale was gained the hard way, and I share it in the hope that others will have a gentler and smoother learning curve.

Why Do Organizations Aspire to Scale?

If scale is less a state of being and more a way of thinking about social problems, then what is it that compels nonprofit organizations to adopt it as an operating principle? Put another way, why do organizations sometimes feel compelled to grow beyond their founding communities?

The noblest answer is that organizations are compassionately compelled by the need for their services. If an organization feels morally obligated to address a social problem in its own community, it is very difficult to turn a blind eye to similar problems in other communities. Many social problems are diffuse and portable, crossing city and state lines and following vulnerable individuals as they move from place to place. It is by no means a simple thing for an organization to define and adhere to a strict geographic focus.

There are other factors that motivate organizations to scale. Fundraising is probably the least worthy of these. Funders tend to like growth, especially those funders with experience in the corporate sector, where growth and success are often thought of as two sides of the same coin. All things being equal, organizations that can tell a scaling story will find it easier to raise more money each year—which creates a powerful incentive, even if (as discussed below) this can simultaneously create a perilous funding trap. There are

national (as opposed to local) funders, too, that are generally accessible only to scaling organizations. The amount of funding available in this vein, however, tends to be much smaller than organizations may imagine it to be. The vast majority of domestic American philanthropy is highly local in nature, even if many of the household-name grant-making foundations gravitate toward national organizations.

Another factor is the undeniable prestige attached to scaling organizations, whether deserved or not—particularly those that expand across state or national borders. It can be viewed as a sort of validation when an organization is invited to serve a new community, even if the invitation came as the result of significant lobbying on that organization's part. Scaling organizations also find themselves the recipients of national press and policy-making attention much more frequently than organizations focused on a single community. (There are some notable exceptions to this, such as the Harlem Children's Zone, which has received considerable national media attention and even spawned an initiative by the federal government without ever expanding beyond its original neighborhood focus.)

Regardless of the reasons for scaling, organizations need to be thoughtful about the benefits and drawbacks of this mind-set. If done well, a scaling approach can exponentially increase an organization's impact, driving it toward making true and meaningful progress in combating devastating social ills. If done poorly, scaling can be a disruptive diversion of precious resources that commodifies rather than serves communities of need.

Mission Benefits of Scaling

1. Consistent and compelling outcomes. Solving social problems is much easier when there are common metrics that can be used to measure the impact of different programs. Scaled organizations usually have an internally consistent evaluation regime that enables them to compare program effects across diverse populations and environments and to present those outcomes in a compelling way to funders, policy-makers, and other stakeholders.

2. **More efficient resource allocation.** It is often challenging for local organizations to find economies of scale, particularly for back-office functions. Scaled organizations are able to centralize administrative functions and share business services across their network. This dual benefit lowers overhead costs and frees up local staff to focus more on program delivery and stakeholder engagement.
3. **Enhanced capacity for research and development.** Scaled organizations are not only able to spend more in real dollars on program development and research but also often allocate a higher overall percentage of their budget to these activities. Organizations that serve multiple communities also have the freedom to try new approaches in discrete parts of their network without fearing that they have “bet the farm” on their success.
4. **Ability to exert sector influence.** Scaled organizations have the ability not only to provide high-quality services but also to share what they’re learning across the sector. With more resources for formal research and program evaluation, scaled organizations can play the role of both thought leader and trendsetter, helping smaller organizations to improve their impact even if they don’t have the capacity to do research work themselves.
5. **Availability of tools for reform-oriented leaders.** When a community leader sets out to address a pressing social need, there may not be an existing local organization that is prepared to take on the challenge. Scaled organizations can support these leaders by providing proven, scalable programs (and models) that can often be imported much more quickly and less expensively than building a new local organization from scratch.
6. **National issue advocacy.** Organizations spanning multiple cities and states are in a better position to raise national awareness of their issue and to engage with federal policy-makers and funding agencies. Scaled organizations also tend to have better-known brands that can be leveraged to drive more resources toward their issue, benefiting the sector as a whole.

Mission Challenges of Scaling

1. **Lack of local saturation.** While there is not always a direct trade-off between having greater impact in one community and expanding to serve another, organizations run the risk of finding their services stretched a mile wide and an inch deep. This can both drive up costs per unit of service and cause a lack of focus that undermines the organization’s ability to make meaningful progress on the issue in any of the communities it serves.
2. **Commodification of place.** Every community is distinct, yet scaling organizations can come to think of each replication site as just another dot on the map. The unique struggles facing these individual communities can be reduced and oversimplified, or lumped neatly into specious categories based on their surface-level similarities. This can have negative effects on local stakeholder engagement and can undermine the success of the organization’s stated mission.
3. **Dependency on external funding sources.** The dark side of the national attention and dollars that scaled organizations can bring to their issue is that they can create unsustainable structural deficits at the local level. Funders from outside the community often end up providing de facto subsidies for services that local stakeholders rely on, creating a potentially problematic dependency—especially if those national funding sources change in geographic focus.
4. **Expansion funding trap.** A related challenge is the temptation for a scaling organization to use new funds from expansion sites to backfill deficits in core operations. Expansion funding is typically much easier to secure than general operating funds and can mask underlying structural issues with an organization’s funding model, forcing it to grow in order to maintain its financial viability.
5. **Unintended consequences for existing local nonprofits.** Every community has existing organizations working to address social challenges that exist in balance with the local funding and resource base. The entrance of a new outside organization can upset the local ecosystem, disrupting resource streams for existing organizations in ways that could

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actually create a net decrease in services available for the community.

6. **Missed opportunity for network leverage.** The least expensive and least labor-intensive way for an organization to advance its mission in a new community is to enable existing organizations to do it for them. In their zeal to put boots on the ground, however, scaling organizations often don't evaluate the full array of strategies available to them to have an impact within a community. Putting launch funding and energy into a partnership with (or merger with) an existing organization can often be more efficient and less operationally risky.

Best Practices for Locally Beneficial Scaling

If scaling is defined as growing impact to solve social problems, then every organization should seek to scale, even if only within a city block. It is important, however, for organizations to be thoughtful about their scaling practices, especially when their scaling strategy involves expanding to serve new communities.

The driving principle in this thinking should be the local benefit of scaling activities, as measured by mission advancement within that community. Organizations practicing thoughtful, high-impact scaling should:

- **Prioritize communities already served.** Organizations should go as deep as they can and maximize all the vertical growth opportunities possible before considering horizontal growth to new communities.
- **Spend time learning about potential expansion communities.** The process of evaluating a new community for services should span many months (if not years) and should entail an open dialogue with all of the local stakeholders, including other nonprofit organizations with similar or related missions. Organizations should confirm that they are not duplicating good work already happening, even if the organizations doing it are at an earlier stage of development.
- **Have a compelling rationale for being in every community.** Starting a program that serves vulnerable populations is a major commitment that should be based on more than the

availability of funding or an abstract desire to roll out nationally. Organizations should easily and clearly articulate the reasons they've chosen to serve a particular community and explain simply why their presence as a direct service provider is the most effective way—both in operations and cost—to advance their mission locally.

- **Build meaningful partnerships with local stakeholders.** Whether structured or informal, partnerships between local and national organizations should demonstrate the sincere interest of both parties in supporting each other to advance a shared mission. Scaling organizations should strive to be good neighbors that engage collaboratively with local communities.



Like any organizational mantra, the concept of scale in nonprofits deserves studied scrutiny, both within the organization and among its stakeholders. While the nonprofit sector has not produced anything remotely approaching the megalithic reach of leading multinational corporations, we should still think critically about how (or whether) we adopt their structures and approaches.

The greatest danger occurs when the primary motivation of an organization's activities is an interest extrinsic to the community in which it is operating. As their top priority, Walmart and Burger King focus on maximizing overall corporate profit. There is nothing immoral about this: it is precisely what those organizations have been chartered to do. It does, however, necessarily subjugate the best interests of the local communities in which they operate, making them a secondary consideration.

There is much that nonprofit organizations can learn from the corporate sector, but we have a fundamentally different charter: we are required by law to benefit the public good. This requires us to invert the corporate priority structure, placing the best interest of local communities served as our highest priority. This means it is critical that organizations maintain that focus if and when they choose to scale.

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Fair or Foul?

A Review of Federal Tax Laws Governing Unfair Competition

by Gene Takagi, JD, MNA, and Tony Wang, JD, MBA

When nonprofits compete in spaces traditionally operated by for-profits, there are two primary legal issues to contend with: unrelated business income and restraint of trade—both of which were put in place to govern unfair competition, and neither of whose boundaries tend to be all that easy to determine. That these laws are necessary is clear; but, note the authors, “In light of all the constraints on a nonprofit running a profitable business, the alarm of unfair competition rings a little hollow.”

THERE ARE AT LEAST TWO TYPES OF NONPROFIT legal issues that can emerge from nonprofits and for-profits competing in the same field of endeavor.¹ One has to do with unrelated business income, and this is generally resolved between a nonprofit and the IRS (see sidebar on pages 55 through 58 for regulations); the other has to do with allegations of “restraint of trade,” or practices that have an anticompetitive effect on the market.

The second type of problem has emerged most recently when nonprofits have tried to enter or expand into a field dominated by for-profits and where for-profits want to limit the market nonprofits can attract. It is often professional associations that initiate this type of effort, alleging that nonprofits enjoy an unfair advantage or do not meet professional standards—and in many instances the issues are resolved at the local or state level.

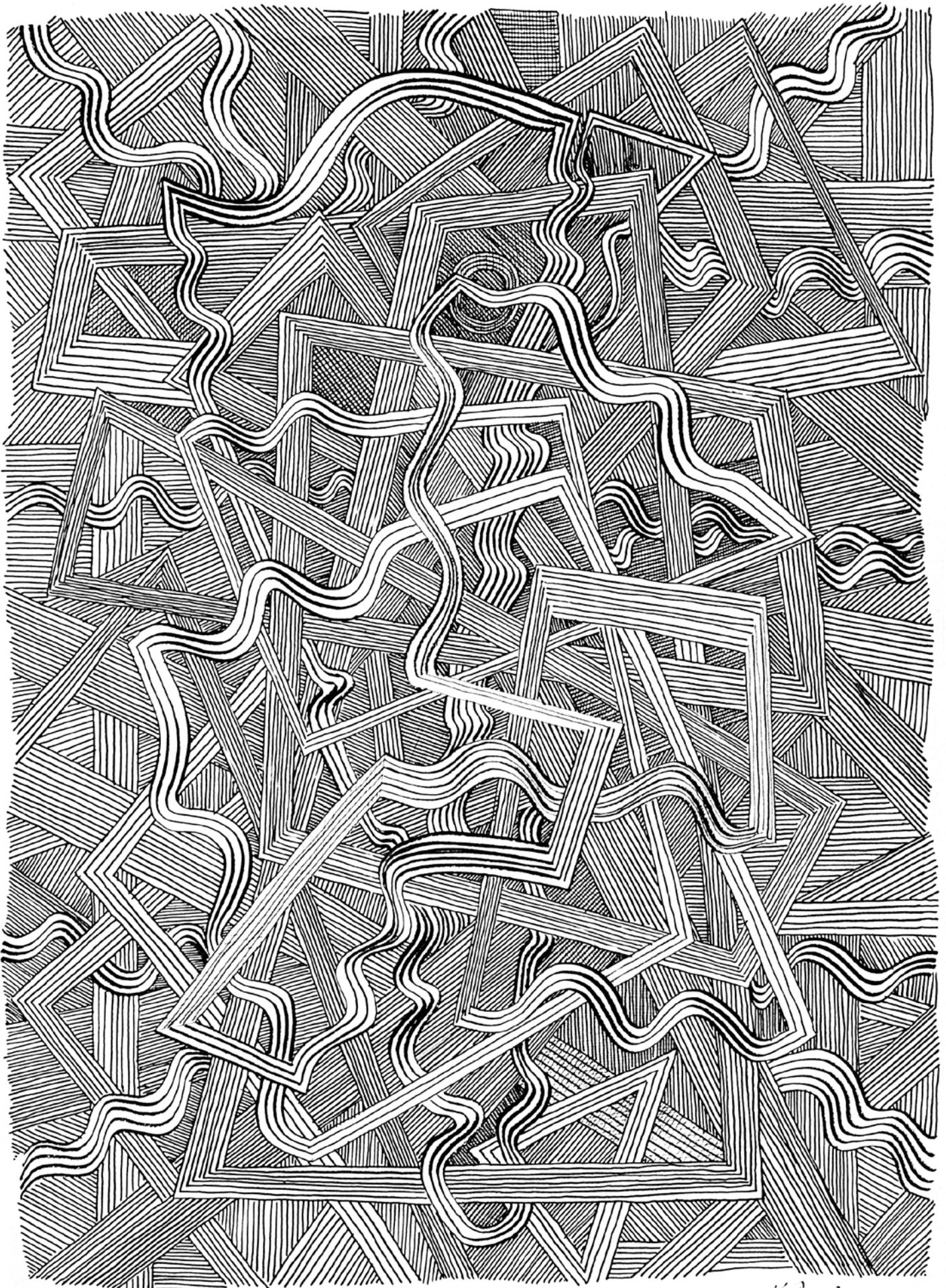
Recent examples of such interactions include the Alabama Dental Association’s (ALDA) opposition to the expansion of the Sarrell Dental Center,

a nonprofit that provides dental services to children from low-income families. As Rick Cohen wrote in 2010, “The interim executive director of the ALDA acknowledged that there’s a problem of inadequate dental services for poor children, but the idea of nonprofit dental clinics in Alabama is ‘new,’ and ‘established dentists aren’t sure what it will mean in the long term.’ . . . At the meeting, participants complained that nonprofits had a business advantage over for-profit dentists, who faced business pressures that nonprofits didn’t. They discussed getting legislation considered by the state to ‘control’ nonprofits.”²

Eventually, the University of Alabama at Birmingham announced it would no longer make its dental students available to work at Sarrell clinics, and Sarrell sued, claiming that the school was being pressured by alumni and private dentists to prevent students from working there. Sarrell ended up filing an antitrust lawsuit against the ALDA in 2011, but later rescinded when Alabama Governor Robert Bentley signed into law Sarrell’s right to operate in the state. The situation was later featured in the *Frontline* documentary “Dollars and Dentists,” in 2012.

In a slight twist, the Idaho Veterinary Medical Association (IVMA) voted this past summer to back a campaign to prohibit animal welfare groups from providing veterinary care to pets of people who are not low income. The campaign was apparently sparked by the Idaho Humane Society’s having received state approval to establish a more centrally located shelter that would

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On the business playing field, nonprofits are increasingly entering into spaces traditionally operated by for-profits, and for-profits are increasingly entering into spaces traditionally operated by nonprofits. The line between the sectors is blurring, and the alarm of unfair competition is being rung on both sides.

also be four times larger than its current facility. Dr. Robert Pierce, president of the IVMA board, said that the planned ten-thousand-square-foot hospital could potentially drive out other smaller, for-profit veterinary facilities.

The most classic conflicts, however, have involved recreational facilities—some of the more recent being challenges to YMCAs. One such conflict occurred in Idaho this past summer, when the Ada County Board of Equalization received a complaint from two for-profit clubs that the West Family YMCA in Boise was running programs similar to their own, and that this should call into question the Y's tax-exempt status. Idaho Athletic Club's chief financial officer Shaun Wardle said, "Those are really the same services that we offer—the health and fitness services. Is it charitable to run on a treadmill? Is it charitable to take a CrossFit class? I'm in that business, I don't necessarily feel that it's charitable and deserves an exemption."³ The Board of Equalization initially agreed, reducing the Y's 100 percent tax-exempt status to 19 percent. The tax exemption was later brought back up to 100 percent, after the Y organized itself to protest.

Similar scenarios have played out across the country with day care centers, theaters, community newspapers, and management consulting firms. On the business playing field, nonprofits are increasingly entering into spaces traditionally operated by for-profits, and for-profits are increasingly entering into spaces traditionally operated by nonprofits. The line between the sectors is blurring, and the alarm of unfair competition is being rung on both sides.

The Concerns of Unfair Competition

If a nonprofit can characterize its income-generating businesses as substantially related to its exempt purpose, the net income from such businesses will not be taxed. This financial incentive to characterize business activity as exempt has over time caused nonprofits to push the boundary of what has historically been recognized as exempt or nonexempt.

This is understandable, given that most nonprofit revenues are earned, not donated. According to the National Center for Charitable Statistics, in 2012 U.S. public charities reported over \$1.65 trillion in

total revenues. Of this, only 21 percent came from contributions, gifts, and government grants, while 73 percent came from program service revenues (including government fees and contracts), and an additional 6 percent came from other sources, including dues, rental income, special events income, and gains or losses from goods sold.⁴

In any event, nonprofits have generally not been criticized for operating enterprises primarily focused on serving socioeconomically disadvantaged individuals traditionally not targeted by for-profits or by government agencies contracting out social services. Cries of unfair competition, however, *are* raised in cases where nonprofits have expanded their services to compete with for-profits in the general public marketplace, with the goal of producing net income. Some nonprofits argue that the production of income from such expansion of services is necessary to subsidize the unprofitable businesses that historically are recognized as related to furthering an exempt purpose. But such justification is based on the old *destination of income* principle that no longer applies under the current tax laws and regulations.

The expansion of nonprofit services must instead be examined with consideration of the following regulation:

In determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function which they purport to serve. Thus, where income is realized by an exempt organization from activities which are in part related to the performance of its exempt functions, but which are conducted on a larger scale than is reasonably necessary for performance of such functions, the gross income attributable to that portion of the activities in excess of the needs of exempt functions constitutes gross income from the conduct of unrelated trade or business. Such income is not derived from the production or distribution of goods or the performance of services which contribute importantly to the accomplishment of any exempt purpose of the organization.⁵

Many nonprofits counter such arguments by stating that their expansion of services to the broader public market still contributes importantly to accomplishing their exempt purpose. Thus, even as more and more members of the general public make use of nonprofit services (often at commercial market rates), YMCAs still run health clubs and yoga programs to improve community health, and SPCAs and humane societies operate veterinary clinics to promote animal welfare and prevent cruelty to animals. Under the same rationale, Girl Scouts have justified selling cookies, a nearly \$800 million business, as mission related in educating girls and building their courage, confidence, and character.⁶

Other commercial activities increasingly claimed as mission related and exempt—without any long-standing historical recognition as such—are less immune to objection. Consider the open source software movement.

The development of software as a charitable endeavor is a relatively new undertaking, with potential commercial implications. The two principal inquiries to determine whether an open source software organization qualifies or fails to qualify as exempt are:

1. Is it operated for a charitable or educational purpose?
2. Is it providing a private benefit to any person or entity that is more than incidental, quantitatively and qualitatively, to the furthering of the organization's charitable or educational purposes?

The development and distribution of open source software may be charitable where the goal is to provide access to such resources to disadvantaged populations that might otherwise not have such access for economic or other reasons. However, if the development and distribution of the software do not specifically target such populations, the organization may be conferring a prohibited private benefit upon other persons or entities that may be considered more than merely incidental and could adversely impact for-profit competitors.

For example, hypothetically, if a nonprofit developed open source software that could effectively

and efficiently replace Microsoft Office for all markets, and made that available to the general public for free, it would presumably confer a significant private benefit upon individuals making the switch, adversely impact Microsoft's market share in the office suite software space, and, consequently, reduce the amount of income taxes collected by the federal government (and sales taxes collected by the state government) by the amount that would have been generated by sales of Microsoft Office. If, on the other hand, the nonprofit somehow restricted the distribution only to its targeted charitable class of beneficiaries (e.g., socioeconomically disadvantaged communities that otherwise could not afford such software), the activity would more likely be regarded as related to its exempt purpose and not jeopardize its exempt status for violating the private benefit doctrine.

The same two inquiries applicable to open source software organizations can generally be applied to other types of organizations found in both the nonprofit and for-profit sectors, including schools, hospitals, and art galleries. The challenges for open source software organizations seeking 501(c)(3) exempt status are the lack of a strong tradition of recognizing the provision of open source software as an exempt activity, and the advocacy of for-profit software companies defending their turf. Not surprisingly, the IRS has flagged applications for tax exemption by open source groups for extra review, to the ire of many open source advocates.⁷

The appropriate characterization of a nonprofit business as either related or unrelated to its exempt purpose is what drives most of the controversy over unfair competition. But it's not the entire story. Indeed, even for a business activity that is inarguably related to a nonprofit's exempt purpose, notions of whether a nonprofit should receive tax exemption for income generated from that activity may differ. For example, even if a YMCA's operation of a new yoga program clearly and substantially contributes to its exempt purpose, some believe that significant issues about unfair competition remain because the YMCA can potentially take away all the customers from a small business that is also promoting a social purpose of improving community health.

The appropriate characterization of a nonprofit business as either related or unrelated to its exempt purpose is what drives most of the controversy over unfair competition. But it's not the entire story.

Many academic scholars have pointed out that the private sector's complaints about the nonprofit sector's tax exemption with respect to the direct operation of businesses are misplaced and exaggerated.

Similarly, controversies regarding nonprofit veterinary clinics exist despite the relatedness of their commercial activities to their exempt purpose of "preventing cruelty to animals." Critics argue that offering low-cost services without discriminating based on a person's ability to pay unfairly harms private for-profit practitioners. Moreover, they rationalize that there is no point in subsidizing a nonprofit to provide services that can be performed just as efficiently by for-profits.⁸

What these examples illustrate is that whether nonprofit commercial activity is considered related or unrelated to an exempt purpose is not perfectly correlated to our notions of fairness. Even if it were possible to appropriately characterize all nonprofit businesses as purely related or unrelated, allowing related business income to be exempt may seem unjustified in cases where the nonprofit's activities are not correcting a failure in the market to provide goods and services of suitable quality, but is instead taking away customers already served by for-profit companies and potentially distorting the market rather than advancing important policy goals.

A Rebuttal

Many academic scholars have pointed out that the private sector's complaints about the nonprofit sector's tax exemption with respect to the direct operation of businesses are misplaced and exaggerated.⁹ From a nonprofit's perspective, since most forms of passive investment income are exempt from taxes, there is no reason for nonprofits to directly manage unrelated businesses if they can make the same return in a diversified portfolio of debt and equity, without all the burdens and risks of managing a wholly owned business. While there are exceptions to this rule, most notably when a nonprofit can leverage its charitable operations to reduce its costs and receive a higher return from running an unrelated business rather than passively investing, academics argue that overall the nonprofit charitable deduction has a minimal effect on competition.

The challenge, however, with these academic arguments is that they sometimes fail to capture much of what actually happens in the real world. These arguments are often based on an unstated

and implied assumption that nonprofits will always be operated pursuant to rational decisions to maximize financial returns or charitable impact. However, realities often dictate that nonprofits make decisions based upon a wide variety of factors other than purely maximizing impact or financial gain. Moreover, the arguments fail to consider that businesses operated by nonprofits often pursue a mix of social and financial goals where the law does not provide clear guidance on the sufficiency of their relatedness to the nonprofits' exempt purposes. Couple these issues with the problems of enforcement discussed on pages 55 through 58, and the argument regarding unfair competition warrants further examination.

As a side note, for the many nonprofits that operate with very little net income from their businesses, the advantage offered by exemption from taxes on their income may be far less important than the advantage offered by exemption from taxes on their property. Property tax, which generates more revenue for the states than do the individual and corporate income taxes combined, is a matter of state law.¹⁰ And the states are where much of the battle over unfair competition and the charitableness of self-declared related businesses takes place.¹¹

The Future

The movement toward social enterprises that we've seen in the last decade is beginning to reshape both the nonprofit and for-profit sectors, and the line between the nonprofit and for-profit sectors continues to blur.

Nonprofit organizations are increasingly entering into traditionally commercial spaces in an effort to increase revenues as they face simultaneous challenges of uncertain philanthropic funding, diminishing governmental funding, unstable fundraising revenues, and increased competition for limited resources. For-profit entities are similarly operating in an increasingly competitive market and seeking to differentiate themselves and generate goodwill by self-identifying as social enterprises, sustainable businesses, and/or certified B Corps, sometimes with sincere motives and other times primarily for marketing purposes.

While tax exemption may be a significant advantage in operating a business within a nonprofit, there are also several disadvantages associated with a nonprofit business form, including the inability to raise equity capital, the limitations associated with the operational test, and the prohibitions against private inurement, private benefit, and excess benefit transactions. Further, unlike a for-profit, a nonprofit is subject to state laws regarding self-dealing, charitable trust, and prudent investment, all of which may constrain the most efficient use of business capital. Nonprofits must also overcome unique cultural issues, including mobilizing the support of stakeholders both inside and outside of the organization and overcoming public criticism of their commercial activities.

In light of all of the constraints on a nonprofit running a profitable business, the alarm of unfair competition rings a little hollow. But that assumes sufficient understanding, compliance, and enforcement of applicable laws—which is perhaps more than we have the right to assume for now.

NOTES

1. For the purpose of this article, the term “nonprofit/s” refers to nonprofit organizations exempt under Section 501(c)(3) of the Internal Revenue Code.
2. Rick Cohen, “Alabama: Nonprofit vs. For-Profit Dental Battle,” *NPQ*, April 13, 2010, nonprofitquarterly.org/updates/2187-nonprofit-newswire-alabama-nonprofit-vs-for-profit-dental-battle.html.
3. Holly Beech, “Treasure Valley YMCA Retains Full Tax Exemption,” *Idaho Press-Tribune*, July 4, 2014, www.idahopress.com/news/local/treasure-valley-ymca-retains-full-tax-exemption/article_944c4774-0320-11e4-8a00-001a4bcf887a.html.
4. “Quick Facts About Nonprofits,” National Center for Charitable Statistics, accessed September 23, nccs.urban.org/statistics/quickfacts.cfm.
5. Treas. Reg. §1.513-1(d)(3).
6. Jessica Menton, “Girl Scout Cookies 2014: Where to Buy & Where Does the Money Go?,” *International Business Times*, February 7, 2014, www.ibtimes.com/girl-scout-cookies-2014-where-buy-where-does-money-go-video-1553955.
7. Ryan Paul, “IRS Policy That Targeted Political Groups Also Aimed at Open Source Projects,” *Ars Technica*,

IRS Regulations *for* Nonprofits Operating a Profitable Business

Related versus Unrelated Businesses

The vast majority of earned income by nonprofits is reported to be from businesses substantially related to the advancement of their respective charitable or other tax-exempt purposes.¹² Less than 1 percent of nonprofits’ earned income is from unrelated businesses that do not substantially contribute to furtherance of their exempt purposes.¹³ The distinction between mission-related business and unrelated businesses is important for three reasons:

1. The concern about unfair competition is more often raised where the nonprofit is operating a business that is completely unrelated to its exempt purpose (e.g., a university running a pasta manufacturing company).¹⁴
2. The concern about unfair competition with respect to such unrelated businesses has been partly addressed by the unrelated business income tax (UBIT), which was created to level the playing field between taxable and tax-exempt entities competing in the same commercial space.¹⁵
3. Net income from a nonprofit’s related businesses is not taxed in significant part for the same reason that its donative income is not taxed: Congress believes that the provision of goods and services that substantially contribute to advancing an exempt purpose should be encouraged and subsidized because they otherwise would not be provided by for-profits.¹⁶

Unrelated Business Income Tax

Prior to the Revenue Act of 1950, which introduced the UBIT, charitable nonprofits were exempt from federal income taxes on all income, including earned income, regardless of whether such earned income derived from

related or unrelated businesses.¹⁷ Further, whether a nonprofit was classified as charitable and qualified for tax-exemption depended not on how its income was earned but on whether it was used to further the nonprofit's exempt purpose. This "destination of income" principle allowed for the creation of tax-exempt "feeder organizations" that operated purely commercial businesses that passed on income to charitable nonprofits.¹⁸ And because many nonprofits were not required to file information returns with the Internal Revenue Service, the pervasiveness and extent of nonprofit commercial activities was not well understood.

When the UBIT rules were enacted, the rationale was to eliminate unfair competition by imposing a tax on a nonprofit's net income generated from unrelated business activities. To be considered unrelated business income, the income must be generated by an activity that constitutes (1) a trade or business; (2) that is regularly carried on; and (3) is not substantially related to the furtherance of the organization's exempt purpose.¹⁹ Whether an activity is a *trade or business* turns on whether it is carried on for the production of income from selling goods or performing services, and whether it is conducted with a profit motive. An activity is *regularly carried on* if it is conducted with similar frequency and continuity to a for-profit conducting the same activity. This means that a one-time fundraising event, such as a car wash or a charity auction, if not regularly carried on, will not generate unrelated business income. Finally, the revenues will only be subject to UBIT if the business activity is *not substantially related* to the organization's exempt purpose. This third factor is widely regarded as the most difficult factor to analyze, and involves a highly fact-sensitive inquiry.

To be substantially related, the activity must contribute importantly to accomplishing the organization's exempt purpose other than through the production of income, and whether the generated income is used to fund charitable programs is irrelevant to the determination.²⁰ This prohibition on looking to the manner in which generated income is spent reinforces the underlying rationale of UBIT—to prevent tax-exempt organizations from having an unfair competitive advantage over for-profit entities engaging in the same business activity.

Federal law provides multiple exceptions for activities that may otherwise be considered to generate unrelated business income subject to

taxation. Some of the more common of these exceptions include income generated from business activities for which substantially all of the work is performed by volunteers; a business carried on primarily for the convenience of an organization's members, students, patients, officers, or employees; a business selling merchandise if substantially all of the merchandise has been donated to the organization; and the distribution of low-cost items as part of charitable fundraising efforts.²¹ Another exception applies to qualified sponsorship payments made to an exempt organization if there is no arrangement or expectation that the payor will receive any return benefit in connection with the payment. There are also exceptions from UBIT that generally apply to certain forms of passive income, including real property rental income; interests, dividends, and annuities; royalty payments; and certain capital gains from the sale of property.²² A nonprofit's net unrelated business income that does not qualify for one of the applicable exceptions or exclusions is taxed at the rates applicable to corporations or trusts, depending on the organization's legal structure.²³

Operational Test and Commerciality Doctrine

Nonprofits are also subject to the operational test and the commerciality doctrine, which serve to restrict the income-generating activities they may engage in. The *operational test* provides that a 501(c)(3) organization must be operated primarily for one or more of the exempt purposes set forth in Internal Revenue Code Section 501(c)(3).²⁴ Only an "insubstantial part" of the organization's activities may be devoted to non-exempt purposes, such as operating an unrelated business.²⁵ While operating a related business would not adversely impact an organization's 501(c)(3) status, its primary purpose must not be to carry on an unrelated trade or business. The regulations provide that in determining the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size and extent of the unrelated trade or business and the size and extent of the organization's activities that are in furtherance of one or more of its exempt purposes.²⁶

Under the *commerciality doctrine*, a court-created derivative of the operational test, if a nonprofit is operating in a manner that is too commercial, it may risk losing its exempt status. In applying the commerciality doctrine, the IRS or the courts will generally look to

whether a nonprofit is engaging in activities that are in direct competition with those of for-profits.²⁷ In assessing commerciality, courts have considered such factors as:

- The extent to which the nonprofit provides below-cost services;
- Pricing policies, including whether the nonprofit is adopting pricing in order to maximize profits;
- The nonprofit's business and marketing practices, including whether the nonprofit is engaging in commercial marketing methods (such as advertising), employs a paid staff (as opposed to primarily relying on volunteers), and discontinues unprofitable programs;
- The reasonableness of the nonprofit's financial reserves;
- The nonprofit's customer base, including whether it primarily sells to the general public as opposed to a discrete charitable class;
- Whether the nonprofit is receiving substantial public charitable contributions.²⁸

The limitations created by the operational test and commerciality doctrine make it difficult for a nonprofit to directly operate one or more unrelated businesses that collectively might appear to be substantial in size in relation to its total activities. Because failing the operational test would result in loss of exempt status, nonprofits with businesses that might be considered both substantial and unrelated are typically counseled to consider dropping such businesses into a wholly owned for-profit taxable subsidiary, which will be subject to the same taxation rules as other for-profits. For example, the nonprofit National Geographic Society operates its publishing services, digital media properties, and television channels through for-profit subsidiaries such as National Geographic School Publishing, Inc., National Geographic Ventures, and National Geographic Channel. Similarly, the nonprofit Mozilla Foundation wholly owns the Mozilla Corporation, which handles the development and commercial-revenue-generating activities of the popular Firefox browser.

The operational test and commerciality doctrine help to address the concern over nonprofits competing with for-profits in businesses that would be considered unrelated to the nonprofits' exempt purposes. Additionally, nonprofits face several other restrictions that would hinder their ability to enter into the purely commercial playing

field in competition with for-profits, including federal tax law prohibitions against private benefit, private inurement, and excess benefit transactions.²⁹

Private Benefit Restrictions

To qualify as exempt under Internal Revenue Code Section 501(c)(3), an organization must serve a public rather than a private interest.³⁰ To satisfy this requirement, referred to as the *private benefit doctrine*, the organization must establish that it is not operated for the benefit of private interests. This does not mean that the organization is entirely prohibited from conferring benefits to individuals; rather, it provides that such benefits must be incidental—quantitatively and qualitatively—to furthering of the organization's exempt purposes.³¹

An organization will similarly fail to qualify as a 501(c)(3) organization if any part of its net earnings inure to the benefit of any private shareholder or individual.³² This requirement, known as the *private inurement doctrine*, generally prohibits a 501(c)(3) organization from using its assets for the benefit of a person having a personal and private interest in the organization's activities (i.e., an insider such as a director, officer, or key employee).³³ An organization that engages in an inurement transaction (e.g., paying an unreasonable compensation to an insider) may face revocation of its exempt status.

While the private benefit and private inurement doctrines appear very similar, there are two important differences. First, the private benefit doctrine is much broader than—and indeed subsumes—the private inurement doctrine, because it applies whenever an impermissible benefit is being conferred on any private party, not just insiders. Second, unlike the case with private inurement, a prohibited private benefit may not cause a loss or denial of exempt status. But if the transaction involves one or more insiders known as “disqualified persons,”³⁴ it may fall within the definition of an *excess benefit transaction*³⁵ and subject the organization, the disqualified person, and even board members who knowingly approved the transaction to significant penalty taxes.³⁶ These limitations, which for-profits are not subject to, serve to limit the ways in which individuals can personally benefit from the income generated by a nonprofit, including through unrelated business activities.

Lack of Enforcement

The vagueness of the law surrounding what is substantially related to furthering an exempt purpose and what is not makes consistent compliance and enforcement impracticable. In a final report of its Colleges and Universities Compliance Project, the IRS stated that 90 percent of the examined institutions underreported unrelated business income (“UBI”).³⁷ Among the primary reasons for the underreporting were the following: misreporting unrelated business activities as related activities; reporting losses as connected to unrelated business activities when they were not (thereby lowering their UBIT liability); and misallocating expenses that were used to carry out both exempt and unrelated business activities and then applying an excessive portion to offset UBI.³⁸ The report’s executive summary concluded: “The examinations of college and universities identified some significant issues with respect to both UBI and compensation that may well be present elsewhere across the tax-exempt sector. As a result, the IRS plans to look at UBI reporting more broadly. . . .”³⁹

In 2014, the Advisory Committee on Tax Exempt and Government Entities (ACT), appointed by the Department of the Treasury, recommended that the IRS Exempt Organizations Division publish a comprehensive revenue ruling on a range of UBI issues, including identification of categories of activities that would be considered related or unrelated.⁴⁰ The ACT further recommended rejecting application of the commerciality test as long as an organization’s income and its financial resources were used commensurate in scope with its charitable program.⁴¹ This recommendation likely stems from the uneven application of the commerciality doctrine and the ACT’s assertion that “[n]either the tax law nor the implementing regulations provide support for a commerciality test.”⁴² It remains to be seen whether these recommendations will be adopted and implemented.

Vague regulations both contribute to and compound the weakness of IRS enforcement, which has faced particular scrutiny and criticism since the revelation in 2013 of its inappropriate handling of exemption applications containing certain names or political themes. With insufficient resources to adequately oversee a sector of over 1.4 million exempt organizations⁴³ and subject to crippling budget cuts that exacerbate the enforcement challenges it is already facing, it’s unlikely that the Exempt Organizations Division of the IRS will be able to significantly strengthen its enforcement program in the near future.⁴⁴ The severity of this problem will likely be amplified by the July 2014 introduction of Form 1023-EZ, the short form exemption application that will allow a vast majority of smaller organizations to apply for and receive 501(c)(3) status while providing almost no description of their existing and contemplated activities.

July, 2, 2014, arstechnica.com/tech-policy/2014/07/irs-policy-that-targeted-tea-party-groups-also-aimed-at-open-source-projects/.

8. Henry B. Hansmann, “Unfair Competition and the Unrelated Business Income Tax,” *Virginia Law Review* 75, no. 3 (April 1989): 605, 625.

9. *Ibid.*, 609–12. See also Michael S. Knoll, “The UBIT: Leveling an Uneven Playing Field or Tilting a Level One?,” *Fordham Law Review* 76, no. 2 (November 2007): 857, 866–70.

10. Knoll, “The UBIT,” 879.

11. See, for example, Ruth McCambridge, “Alabama’s Persistent Nonprofit/For-Profit War Extends to Animal Clinics,” *NPQ*, May 7, 2013, nonprofitquarterly.org/policysocial-context/22251-alabama-s-persistent-nonprofit-for-profit-war-extends-to-animal-clinics.html.

12. “Table 1. Unrelated Business Income Tax Returns: Number of Returns, Gross Unrelated Business Income (UBI), Total Deductions, Unrelated Business Taxable Income (Less Deficit), Unrelated Business Taxable Income, and Total Tax, by Type of Tax-Exempt Organization, Tax Year 2010,” Department of the Treasury Internal Revenue Service, last modified April 23, 2014, www.irs.gov/uac/SOI-Tax-Stats-Exempt-Organizations'-Unrelated-Business-Income-UBI-Tax-Statistics. It states that \$7,115,467,000 in gross unrelated business income was reported by all 501(c)(3) organizations in 2010; compare to over \$1.1 trillion in program service revenues reported by 501(c)(3) public charities in 2010, in Paul Arnsberger, “Nonprofit Charitable Organizations, 2010,” *Statistics of Income Bulletin* (Winter 2014): 75, www.irs.gov/pub/irs-soi/14eowinbulcharitorg10.pdf.

13. *Ibid.*

14. See, for instance, *C. F. Mueller Company v. Commissioner*, 190 F. 2d 120 (3rd Cir. 1951), in The Joint Committee on Taxation, *Historical Development and Present Law of the Federal Tax Exemption for Charities and Other Tax-Exempt Organizations* (JCX-29-05), April 19, 2005, 101–2.

15. Treas. Reg. §1.513-1(b) states that “[t]he primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete.”

16. Heather Gottry, "Profit or Perish: Non-Profit Social Service Organizations & Social Entrepreneurship," *Georgetown Journal on Poverty Law & Policy* 6 (Summer 1999): 249, 256.
17. See the Joint Committee on Taxation, *Historical Development and Present Law of the Federal Tax Exemption for Charities and Other Tax-Exempt Organizations*, 100–101.
18. *Ibid.*, 101.
19. 26 U.S. Code §513. See also *Tax on Unrelated Business Income of Exempt Organizations*, IRS Publication 598 (Washington, DC: Department of the Treasury Internal Revenue Service, 2012), www.irs.gov/pub/irs-pdf/p598.pdf.
20. Treas. Reg. §1.513-1(d)(2).
21. 26 U.S. Code §513(a), (h).
22. 26 U.S. Code §512(b).
23. 26 U.S. Code §511(a)(1).
24. Treas. Reg. §1.501(c)(3)-1(c)(1).
25. *Ibid.*
26. Treas. Reg. §1.501(c)(3)-1(e)(1).
27. See *Airlie Foundation v. Internal Revenue Service*, 283 F. Supp. 2d 58, 63 (D.D.C. 2003).
28. *Ibid.* See also W. Marshall Sanders, "The Commerciality Doctrine Is Alive and Well," *Taxation of Exempts* (March/April 2005): 209, 211.
29. Private foundations face further restrictions under federal tax law that affect their ability to invest in and operate purely commercial businesses, including prohibitions against self-dealing, excess business holdings, jeopardizing investments, and taxable expenditures.
30. Treas. Reg. §1.501(c)(3)-1(d)(1)(ii).
31. Department of the Treasury, *Internal Revenue Service General Counsel Memorandum* 39862, Nov. 21, 1991.
32. See U.S. Code §501(c)(3).
33. Treas. Reg. §1.501(c)(3)-1(c)(2).
34. 26 U.S. Code §4958(f)(1) defines a *disqualified person* with respect to a transaction as "(A) any person who was, at any time during the five-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization [including directors of the corporation], (B) a member of the family of an individual described in subparagraph (A), (C) a 35-percent controlled entity. . . ."
35. 26 U.S. Code §4958(c)(1)(A) defines an *excess benefit transaction* as "any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit."
36. 26 U.S. Code §4958(a).
37. See Exempt Organizations Division, *Colleges and Universities Compliance Project Final Report*, revised May 2, 2013 (Washington, DC: Department of the Treasury Internal Revenue Service, 2013), 11, www.irs.gov/pub/irs-tege/CUCP_FinalRpt_042513.pdf.
38. *Ibid.*, 10–14.
39. *Ibid.*, 6.
40. Advisory Committee on Tax Exempt and Government Entities (ACT), *2014 Report of Recommendations*, Publication 4344 (Rev. 6-2014), Catalog Number 38578D (Washington, DC: Department of the Treasury Internal Revenue Service, 2014), 160, www.irs.gov/pub/irs-tege/tege_act_rpt13.pdf.
41. *Ibid.*, 80.
42. *Ibid.*, 157–58. (The report further states that "the evidence is clear that the imposition of tax under the Corporation Excise Tax Act of 1909, from which the present income tax exemptions are derived, does not indicate any intention to limit the tax exemption of charities engaged in business or to limit the quantum of business activity, but rather indicates an intention to assure exemption of certain charities engaged in businesses.")
43. "Quick Facts About Nonprofits."
44. National Taxpayer Advocate, *2013 Annual Report to Congress Executive Summary: Preface and Highlights*, Publication 2104C (Rev. 12-2013), Catalog Number 23655L (Washington, DC: Department of the Treasury Internal Revenue Service, 2013), 3, www.taxpayeradvocate.irs.gov/userfiles/file/2013-Annual-Report-to-Congress-Executive-Summary.pdf. (The report states that "[t]he IRS has been chronically underfunded for years now, at the same time it has been required to take on more and more work, including administering benefit programs for some of the most challenging populations . . . [and] without adequate funding, the IRS will fail at its mission.")
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Saving John's Carpet House, Saving Civil Society?

by William Schambra

While foundations enthusiastically engage in supporting Detroit's museums, and mainstream media celebrate the influx of "young, white, creative hipsters" into the city's wealthier neighborhoods, many of the more diverse artistic and entrepreneurial expressions of civil society are largely ignored—or, worse, shut down. This article is an explicit call to action for the philanthropic sector to come to the defense of civil society in the pure and raw form found in Detroit.

Editors' note: This article was originally published on NPQ's website, on August 12, 2014.

THE GOOGLE STREET VIEW FOR 2133 Frederick Street in Detroit, Michigan, reveals what seems to be a typical scene in the heart of that beleaguered city—namely, utter desolation. Not a house in sight. Patches of old driveways and sidewalks and crumbling street curbs.

But if you look a bit closer, you'll notice something else: no trash; the empty lots in the foreground are neatly mowed; and there's a makeshift stage in the corner of one of the lots. For this is the site of John's Carpet House and Pete's Place, where for the past fifteen years "Mardi Gras in the 'Hood" has sprung to life every clement summer through fall Sunday between 3:30 P.M. and dusk.

Danny Fenster, a graduate student in Wayne State University's English department and a fan of the Detroit blues featured at the Carpet House, lovingly blogs about this "institution on the east side, a weekly display of vibrant, thriving life in an otherwise seemingly desolate area."¹ (His pieces appear regularly on the online news site *Deadline Detroit*, another scrappy survivor of the city's hard times.)

Fenster notes that the Sunday tradition began when John Estes lived at 2133 Frederick. Estes was a junkman by profession but a drummer and blues lover by avocation. He built a wooden shed in front of his house, padded it with carpeting for acoustical purposes (hence "John's Carpet House"), and put on weekly jam sessions for the neighbors, who watched from across the street.

After John died, his house quickly went the way of all abandoned structures in Detroit and burned down. But Pete Barrow, a fellow blues lover, revived the tradition of weekly jam sessions in the now-vacant lots at the intersection of Frederick and St. Aubin (hence "Pete's Place"). Soon, hundreds of people were gathering to hear live performances, along with Barrow providing DJ services from his vast collection of blues CDs.

"Famous names from Motown and soul music's past and present have been known to show, including Smokey Robinson and members of the Contours and Romantics," Fenster writes.² The events were free, though Barrow passed the basket every Sunday—with the admonition to "put some ducats in the bucket"—to buy

gasoline for the generator, keep the grass mowed, and, after the portable toilet was stolen, to buy a new one. Along with canopies, blankets, and lawn chairs, people began bringing grills, with some selling burgers, ribs, and sausages.

"Nobody is a stranger here," Fenster quotes one patron as saying. "Everybody here is family. If you're hungry, somebody's gonna feed you; if you're thirsty, somebody's going to give you something to drink. Whatever you need."³ In spite of no security presence and just a few rules—"no drugs, no time," reads one of Estes's signs—this ad hoc and diverse community in the heart of one of the nation's most violent cities has rematerialized every clement weekend for fifteen years without incident.

Ironically, the only threat to this scarce and desperately needed stirring of civic energy has been posed by officials of the city of Detroit. Some years ago the police tried to shut it down, but they backed off after Barrow purchased the eight vacant lots where the event took place. He was led to believe, he insists, that as owner of the property his gatherings could now be considered private events.

But on a Sunday in late July, the police were back, and they closed down the gathering. “They say we need an entertainer’s license—they ain’t never had that before. And they say the food vendors, they have permits but not licenses or something—I don’t know, they shut everybody down,” Barrow explained to Fenster in tones familiar to anyone who’s tried to navigate City Hall’s labyrinthine licensing and permitting processes.⁴

Police promised to return by 5:00 P.M. to ticket any of the cars still parked in the area. This in a city where, until recently, it took fifty-eight minutes for the police to respond to 911 calls, and where only 8.7 percent of crimes were solved—and in a neighborhood where, as the Google Street View suggests, parking irregularities aren’t likely to trouble residents even if there were any.

As of August 3, the jams were back in session (food vendors were still banned), but given its history, it’s probably just a matter of time before the city moves against John’s Carpet House again. This will be bad news for those of us who are fans of civic institutions—not the towering, well-financed, professionally staffed nonprofits that are indistinguishable from government agencies or corporations, but the tiny, scruffy, all-but-invisible grassroots groups that assemble quietly (or with somewhat louder blues accompaniment) to build something that everyday citizens want in their own lives, in their own ways.

Robert Woodson (recently both acclaimed and denounced for mentoring Congressman Paul Ryan on the problems of poverty) has insisted for decades that such groups spring up in the most unlikely places, after all other major agencies of business, government, and charity have fled. At a moment when we’re all too inclined to regard voluntary activity as nothing more than the leisurely hours put in by the children of affluence in order to

bolster their resumes, it’s useful to recall that for many Americans volunteerism isn’t just a pleasantry or an afterthought; rather, it’s the difference between flourishing and declining—the only way to pull themselves out of the despair so widespread in our central cities.

Nowhere has this proven to be truer than in Detroit. Far beneath all the high-flying financial wheeling and dealing now underway to pull it out of bankruptcy, and well outside the fortified enclaves along the riverfront that define the hip, high-tech “new Detroit” in the glossy magazines, everyday citizens have come together to make new lives for themselves in the face of decay so profound and so widely photographed that “ruin porn” has now entered our vocabulary.

In 1995, Motor City Blight Busters, which for twenty-five years has demolished or rehabilitated hundreds of houses, launched “Angel’s Night”—a countermeasure, unofficially put into practice some five or so years earlier, to the widespread “Devil’s Night” arson spree that has marred Detroit’s Halloween for decades. Toni McIlwain’s Ravendale Community Center keeps civic agency alive in that hard-pressed neighborhood. The Heidelberg Project draws crowds from around the world to see its collection of quirkily decorated derelict structures. East Side Riders developed from an informal bicycle club into a neighborhood program for youngsters who are taught to decorate and maintain their bikes, which they use for community outings.

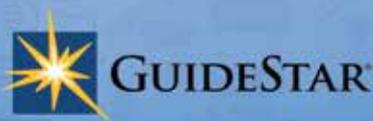
In early August 2014, the *Detroit Free Press* ran a story about Dan Davis, who has converted the vacant lots around his house on Washburn Street into an outdoor movie theater for families and children, and a playground, gym, and, across the street, a go-kart track, with five hundred used tires stacked to provide bumpers around the track. “He’s like an icon around here. What he does

for the neighborhood, people look up to him for it,” noted a friend.⁵

And, of course, there’s John’s Carpet House. As Edward McClelland pointed out in *Nothin’ But Blue Skies: The Heyday, Hard Times, and Hopes of America’s Industrial Heartland*, “by showcasing African-American culture in a setting that was at once inner-city and pastoral, John’s Carpet House is not just quintessentially Detroit, it is *uniquely* Detroit. These blues, this barbecue, the empty fields, the cars . . . composed a scene that could not exist anywhere else in the world. Detroit is a great place to spend a fall vacation, if you know where to find the empty spots on its map.”⁶

Fenster underlines the connection between these ventures and the larger cause of civil society: “The resilience of Detroiters and the DIY ethic the city has garnered and is lauded for exists in these sorts of efforts—the communal repurposing of the seemingly empty spots on the city’s map, the informal networks of musicians and artists and showspaces.”⁷

How things will fare with the “empty spots on the map,” some of which are in fact not at all empty but rather brim with civic energy, may well determine the future of civil society in Detroit—for the problem is that Detroit’s mainstream civic institutions are clearly ambivalent about these DIY efforts. If the city has tried repeatedly to close down the Carpet House, one can only imagine what its hitherto somnolent bureaus will do now that the *Free Press* has disclosed the existence of an utterly unlicensed, unregistered, unregulated go-kart track built out of old tires by a mere citizen. The headline of the paper’s follow-up story—“Detroiter who shows love for his block gets love, donations in return”—is not likely to be echoed in the no doubt pending official health and safety investigations.⁸



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In the past, we might have written off the suppression of spontaneous civic activity as the inevitable result of modern organization. After all, isn't the path of history away from amateur, DIY efforts and toward professionalization and centralization, with the private and voluntary inevitably being displaced by the public and tax-subsidized? That argument has always been somewhat schematized along the lines of and related to the "secularization thesis," according to which modern scientific rationality would inevitably drive out religious superstition. As theologian Harvey Cox noted in *Fire from Heaven*, that notion didn't survive the rise of the Pentecostal Movement in distinctly modern early twentieth-century Los Angeles, from an obscure revival meeting on Azusa Street to a religious phenomenon gathering in hundreds of millions of believers around the globe, and featuring its own great efflorescence of private, faith-based organizations.⁹

At any rate, the example of Detroit suggests that the trend toward professional, publicly funded service provision may have its own historical trajectory, and not always toward bigger and better. Indeed, before the city can think about providing once again even the most rudimentary functions of municipal government, it must work its way out from beneath a mountain of debt accumulated by overpriced public services rendered poorly often decades ago.

Having heard the city's elites' siren call of a "Detroit Renaissance" many times before, citizens out in the neighborhoods are unlikely to trust that they will now be included in plans for the city's future. This distrust is, of course, only reinforced by the energy the city is devoting to shutting off water to residents who are behind several months or several hundred dollars in payments while apparently ignoring vastly larger debts run up over years by public agencies and sports organizations.

To embattled fans of the Carpet House, this must seem to be just further evidence of the downtown elite's fortified enclave approach for building a "new Detroit" while driving out the gritty, home-brewed institutions of the "old Detroit."

Happily for grassroots civil society, though, new technologies allow everyday citizens to come together and resist the suppression of their DIY energies. Facebook provides a way for Barrow to solicit donations for the Carpet House and to rally neighborhood support in the face of police hostility. Local grad student and blues lover Fenster has kept the attentive public apprised of its plight through his blog. (The indispensable *Deadline Detroit*, itself struggling to stay afloat, hosts Fenster's writing.) NPQ has gotten in on the act through Rick Cohen's fearless and thorough writing about the water cut-offs and the fate of the city's non-elite institutions.¹⁰ Few of these stories about neighborhood civil society have engaged the mainstream media, which has devoted itself almost entirely to celebrating the influx of young, white, creative hipsters to the riverfront redoubts carved out by local millionaires Dan Gilbert and Mike Ilitch.

Sadly, the organizations that should be enthusiastically seeking out and supporting the wonderfully exuberant and diverse expressions of civil society—the city's foundations—are engaged elsewhere. In the so-called "Grand Bargain," they have committed hundreds of millions to the city's public pension funds in order to save the Detroit Institute of Arts. While the DIA features a notable collection of art, every major city in the world can and does make the same claim for its museums. The expressions of culture that are uniquely Detroit's, meanwhile, are ignored, or worse. One wonders, for instance, if some of the cruisers dispatched to silence the blues at the

Carpet House weren't among the scores of cars recently donated to the city by the major automakers.

Where millions have been required to bail out the DIA, and many more millions will be required to build an endowment sufficient to keep it going, it would take but a few thousand dollars to sustain the lives of the Carpet House, Blight Busters, the East Side Riders, and the informal media networks that feature and sustain their work. (To its credit, the Knight Foundation did in fact make a \$10,000 grant last year to the Riders.)

For foundations that are enamored of results-driven grantmaking, it would be easy to measure the impact of a contribution to the Carpet House to replace its portable toilet—and maybe even add one or two. For foundation leaders who insist that they don't just give money but also leverage influence, a few calls to City Hall on behalf of Barrow and his fellow civic

leaders would no doubt work wonders. If foundations cannot act unless in pursuit of some grand strategic scheme, they can categorize these efforts under “renewing civic life”—a program title no less true for being rather grandiose.

Progressive foundations—and most of those active in Detroit fall under this heading—might use this occasion to attack the “structural racism” that some claim to be the target of their grantmaking. Insofar as they've focused on attracting young creative types to the city and saving the distinctly elitist Detroit Institute of Arts while ignoring homegrown expressions of African-American culture, progressive funders seem to have been manifesting rather than mitigating the characteristic behaviors associated with structural racism.

But the defense of grassroots civil society in Detroit is a cause that should engage conservative thinkers and

donors as well. The “reform conservatism” enunciated in documents like the YG Network's *Room to Grow* calls for a shift of responsibility from the poor to society's “mediating institutions,” such as neighborhoods, houses of worship, and voluntary associations standing between the individual and the state.¹¹

Although conservatives may have in mind larger semiprivate service providers like Catholic Charities, they must also, as Woodson constantly reminds them, learn to locate, celebrate, and donate to groups like East Side Riders and enterprises like Davis's go-kart track and outdoor movie theater. (Woodson himself has long been a champion of McIlwain's work at Detroit's Ravendale Community Center.)

One of the precepts of reform conservatism is that low-income individuals are frequently blocked from worthwhile entrepreneurial activities by excessive

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licensing and regulation. The suppression of the vendors that had gathered around John's Carpet House provides a perfect case study for this proposition and an opportunity for conservatives to showcase their concern for the poor.

I intend to send this appeal for assistance to acquaintances at Michigan's preeminent conservative think tank, the Mackinac Center for Public Policy. I will also alert the Institute for Justice in Washington, D.C., which has made a name for itself defending street vendors and other low-income entrepreneurs against the oppressive burdens of regulation. I will be sure to report back to *NPQ* readers about any response.

Meanwhile, Fenster noted to me that he will gladly convey anyone who wants to learn firsthand about John's Carpet House to 2133 Frederick on any mutually agreeable Sunday afternoon this fall.

As Fenster notes, "Many [Detroit] communities have established their existence in the absence of a functioning city, and some are fearful that, as the city rebuilds its own capacity, it may knock down what its people have built in its place." They are, of course, right to be fearful. But it would be wonderful if, for once, the philanthropic sector so involved in the city's future did its best to allay those fears, and came to the defense of civil society in the pure and raw form to be found on Frederick Street and elsewhere throughout Detroit.¹²

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Friday Is the New Tuesday— and Other Observations on the “New Normal” in the Nonprofit Arts Sector

by Eileen Cunniffe

While the worst effects of the economic downturn seem to be fading, the 2013 Americans for the Arts National Arts Index shows that larger cultural institutions are still, in effect, in recession. That said, there is some evidence that funding of the arts may be on the rebound.

Editors’ note: *The Nonprofit Quarterly keeps its online readers abreast of the times through a system that uses practitioners as lay correspondents. These volunteers are screened for their capacity to act as educated observers. Their view collectively is wide-angled and multidisciplinary, since as a group they span geographies and fields. Over time, this group weaves smaller stories into NPQ’s reporting of larger trends in the work of nonprofits and philanthropy. This summary focusing on some of the profound changes we have been observing among nonprofits in the arts, by NPQ newswire correspondent Eileen Cunniffe, is one such example, and was originally published on NPQ’s website, on January 10, 2013.*

IN THE WANING DAYS OF 2013, AN ARTICLE in the *Philadelphia Inquirer* cited examples of performing arts organizations experimenting with curtain times, holding some weeknight performances as early as 6:30 P.M. instead of the long-accepted standard of 8:00 P.M.¹ Their reasons included appealing to younger audiences, who might want to go somewhere else after the show; appealing to older audiences, who might appreciate getting home earlier; and appealing to everyone in between, who might find it easier to hire a babysitter or just to show up for work the next day. One of the early trends from this experimentation is that some midweek performances with earlier curtain times are pulling even with or outpacing once-hot Friday evening ticket sales.

In other words, Friday is the new Tuesday—or maybe Tuesday is the new Friday? Either way, this is as good a place as any to begin the conversation about what constitutes the “new normal” for the nonprofit arts and culture sector, and how arts organizations continue to respond to the changing environment in terms of audience behaviors—and, in the wake of the Great Recession, evolving funder behaviors, too.

Looking back at 2013, it was in many ways a year of contradictory trends in the arts sector: two steps forward, one step back, or perhaps the other way around. Growth, contraction, innovation, struggle, resurrection, collapse.

Consider these findings gleaned from the Americans for the Arts (AFTA) National Arts Index in 2013 and previous AFTA research, as reported by NPQ:²

- “Between 2000 and 2010, the number of new nonprofit arts organizations grew 49 percent, . . . faster than all nonprofit organizations, which grew 32 percent.” This trend continued during the recession—3,000 new nonprofit arts organizations were created between 2007 and 2009.
- Even while that was occurring, mainstream nonprofit arts organization attendance was declining.
- In 2011, 18,000 arts organizations either lost their nonprofit status in the Internal Revenue Service crackdown or folded on their own.³

In a recent article in the *GIA Reader* from Grantmakers in the Arts, Rebecca Thomas of the Nonprofit Finance Fund notes, “Most of our nonprofit clients deeply understand the artistic

implications of their broken business models and diminished balance sheets.”⁴

So how are they responding?

Audience retention and development, which often directly generate earned revenue, matter more than ever. And in a wired world where audiences have every opportunity to express their opinions and state their preferences, tweaking curtain times is one way to show responsiveness. Experimenting with smaller venues, shorter performances, public pop-up concerts, and “random acts of culture” are other ways arts organizations have been attempting to attract new audiences, as reported in an October 2013 newswire story that focused on innovative opera companies.⁵ Cross-pollination, collaboration, and audience participation were cited as keys to success in “O, Miami: Poetry Festival Innovates with the Unexpected.”⁶ And squeezing a little culture into the lunch hour—or a happy hour—as in “A Play a Pie and a Pint,” is a model that’s gaining traction internationally.⁷

Other new realities in the arts sector—reduced staff sizes, shifts in funding patterns, an alarming reduction in arts education in public schools, and increasing attention to capitalization and cash flow—have been much harder to navigate. And while there are signs of resilience and perseverance within the sector, there are also plenty of examples of long-standing cultural institutions that have already failed, or are quite publicly struggling to weather the storm. The Americans for the Arts National Arts Index in 2013 shows that larger cultural institutions—especially museums and those in the performing arts—are still, in effect, in recession.⁸

Consider the long-running standoff between the Minnesota Orchestral Association and its musicians, documented over the last many months in *NPQ* newswires.⁹ Or consider all the

other major orchestras—including those in Atlanta, Baltimore, Cleveland, Dallas, Detroit, Philadelphia, and Pittsburgh—that have struggled with structural deficits, union-management issues, and/or bankruptcy since the recession began.

Consider the demise of the New York City Opera, which some consider a suicide, or at least a preventable tragedy, for which a last-ditch effort at crowd-funding was too little, too late.¹⁰

Or consider the reports of asset-rich but cash-poor museums in Baltimore,¹¹ in Chicago,¹² in Pittsburgh,¹³ and in Washington, D.C.,¹⁴ where board, staff, and funders are all wrestling with sustainability issues and, in many cases, fiduciary lapses.

Of course, structural tensions around funding were evident within the sector long before the economy began falling apart in 2008. As noted in the *GIA Reader*:

Capitalization has always been a loaded topic in the arts sector. . . . Historically, strengthening the capital structure of cultural institutions has been misinterpreted to mean investing more money in big organizations, for the purpose of building endowments and facilities. While large groups have indeed attracted the lion’s share of the capital, our research shows that they are often capitalized in the wrong ways; their money is trapped in inflexible assets. Many of these organizations have achieved long-term *durability*, as reflected by the presence of significant fixed assets. But they have done so at the expense of building their own—and the broader field’s—*liquidity* (having regular access to working capital) and *adaptability* (having periodic access to capital for resiliency and change).¹⁵

In fairness to the nonprofit arts community, until a few years ago many funders did not focus on capitalization but instead rewarded organizations that operated at or near breakeven from one year to the next. In fact, those with reserves were sometimes penalized by not being given new grants, and even many trustees and individual philanthropists were inclined to equate “nonprofit” with “breakeven.” This conversation began to shift—because of research that had already been undertaken in prior years—at about the same time the economy began to falter, leaving many arts groups vulnerable when corporate funding, government funding, and individual contributions suddenly dwindled, followed by significant drops in foundation support as the recession lingered.

Still, there was some modest evidence in 2013 to suggest that funding of the arts may be on the rebound, as reported in a July 2013 *NPQ* newswire: *Giving USA 2013* found that arts and culture was America’s fastest-growing philanthropic cause in 2012, and the Americans for the Arts BCA National Survey of Business Support for the Arts showed an increase of 18 percent in business giving to the cultural sector from 2009 to 2012, after downward trends in 2006 and 2009. However, both reports came with asterisks: the BCA survey demonstrated that business support for the arts had rebounded to “near 2006 levels,” leaving plenty of lost ground to be made up.¹⁶ And, as noted in the *Los Angeles Times* following the release of *Giving USA*, a peek behind the curtain of data showing increased support for the cultural sector suggested that many donors still don’t see the arts as essential to society, which is why their gifts went elsewhere during the peak years of the recession.¹⁷

Fortunately, many funders do appreciate the larger implications for society of investing in the arts. To cite just a few examples:

- The Kresge Foundation sees “arts and culture as central to discussions of rebuilding and reinvigorating metropolitan areas as land use, housing, transportation, economic development and other more traditional disciplines.”¹⁸ In fact, this trend to invest in “creative placemaking,” which has been picking up steam in recent years (and not just through Kresge), is a bright spot for the cultural sector and recognizes that artists and arts organizations are vital to communities. It fosters collaboration between arts organizations, and sometimes between arts groups and other sectors, like small businesses.¹⁹ (It’s worth noting, however, that in some instances new investments in creative placemaking mean reductions in or elimination of grants to established cultural entities, like small historic sites or those representing artistic disciplines that may be perceived as being overrepresented within a particular community.)
- The Knight Arts initiative of the John S. and James L. Knight Foundation continues to invest in community-building arts projects in eight metropolitan areas. Knight has for the last few years supported the aforementioned “Random Acts of Culture,” and more recently has launched “Library Acts of Culture.” Knight invests not only in nonprofit arts groups but also in projects led by individual artists or by start-ups that are not 501(c)(3) organizations. This type of project-based funding aims to foster entrepreneurial—and sometimes transient—art making, collaboration, and community engagement. This is a departure from the traditional foundation model of funding only nonprofit arts organizations, and often only those with a track record of three or more years. It reflects a broader

movement afoot in the creative sector, especially among younger artists who would rather take their chances with project grants and crowdfunding than taking on the responsibilities of managing a nonprofit entity.

- PNC Arts Alive is a three-region, multiyear arts funding program from a corporate funder named to the 2013 BCA 10: Best Businesses Partnering with the Arts in America. The focus of these grants is to support performing and visual arts organizations with innovative approaches to expanding audience participation and engagement. In other words, investing in efforts that are likely to retain and develop audiences over time, making the grantees more self-sustaining.

NPQ also reported during 2013 on a number of arts institutions that seemed to be successfully reinventing themselves following fiscal or other crises. While the jury may still be out on the long-term sustainability of the following organizations, their comeback stories offer hope—and hopefully some wisdom—to those still struggling to regroup:

- Detroit Symphony²⁰
- Venture Theatre²¹
- Dance New Amsterdam²²
- Milwaukee Public Museum²³

So again, looking back at 2013, those who work in, volunteer for, fund, patronize, or otherwise contribute to the nonprofit arts sector had some reasons to celebrate. The worst effects of the economic downturn seem to be fading into the rearview mirror—which is not to say there haven’t been casualties, or that there will not be others. But new models are emerging, and while some of these may represent departures from traditional nonprofit structures, they may in fact be good for the arts community—and society—as a whole, if they are nimble and responsive enough to keep evolving

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as the environment changes. In the meantime, the concept of capitalization—which can hardly be separated from the concept of sustainability for many existing arts organizations—is perhaps the theme that most deserves the attention of the sector at this time.

And so we end with a final thought from the Grantmakers in the Arts report cited earlier:

Improving capitalization in the arts will require all cultural supporters—from board members to wealthy donors to philanthropic institutions—to rethink the kinds and amounts of capital that organizations need in a world where new technologies and models of participation are fundamentally challenging traditional assumptions about what art gets created, where, and how. This implies moving beyond some of the static assumptions about money that interfere with artistic experimentation, organizational risk taking, and managing uncertainty or failure.

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Nineteen Practices toward a Nonprofit Theory of Leadership and Organizational Culture

by Jon Pratt, JD, MPA

The accountability principles and management practices outlined in this article were designed by the Minnesota Council of Nonprofits to lay out an explicitly nonprofit set of expectations for leadership from board members, managers, and volunteers.

Editors' note: The following article was adapted from *Principles & Practices for Nonprofit Excellence: A Guide for Nonprofit Staff and Board Members* (Minnesota Council of Nonprofits, 2014), which updates a set of accountability principles and management practices developed by MCN that associations of nonprofit organizations throughout the United States have used as a basis for similar documents in their locales over the past decade. To download the original document, visit www.minnesotanonprofits.org/nonprofit-resources/principles-and-practices/principles-and-practices-for-nonprofit-excellence-2014/principles-and-practices-for-nonprofit-excellence.

NONPROFIT ORGANIZATIONS ARE DIFFERENT from business and government. One would reasonably expect to manage and govern them differently. However, in the absence of a general framework for nonprofit management, third sector organizations are under persistent pressure to look like something else. On the one hand, nonprofits are advised (sometimes by “venture” philanthropists) to become more entrepreneurial and business savvy, orienting their organizations more closely to market forces. At the same time, organizations are increasingly urged to make the reliability and accountability of their “outcomes” their highest priority by controlling internal processes and structuring and orienting themselves as hierarchies.

The following statements on leadership and organizational culture are excerpted from *Principles & Practices*

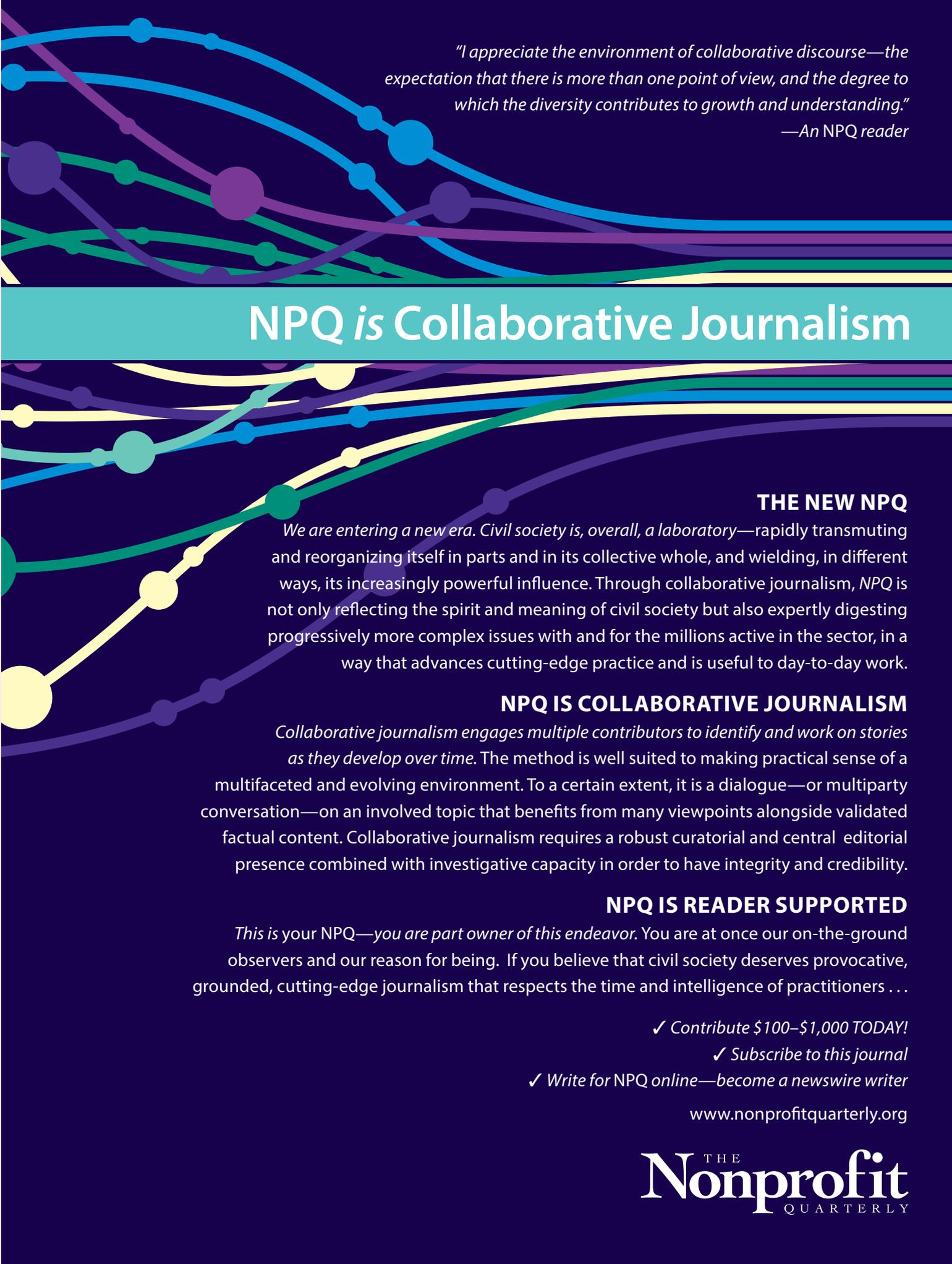
for *Nonprofit Excellence: A Guide for Nonprofit Staff and Board Members*—a forty-page document available for free on the Minnesota Council of Nonprofits website. To facilitate broad participation in important discussions and decision making, these nineteen practices were designed to lay out an explicitly nonprofit set of expectations for leadership from board members, managers, and volunteers.

By engaging diverse groups of people who care about the organization’s work and the people it serves—and thus gaining perspectives from both inside and outside the organization—nonprofits are able to mobilize support, learn from peers, and respond to community concerns. Nonprofit leaders have a complex task: carrying out challenging missions with limited resources and sometimes conflicting demands in the midst of constantly evolving networks of organizational and

personal relationships. Open and interactive leadership practices and organizational cultures strengthen the ability of nonprofits to interpret and adapt to opportunities in this shifting environment, and to make the most effective use of the ideas and resources available in their organizations, networks, and communities.

Decision Making

1. Nonprofit leaders should make clear the decision-making structures and processes of the organization and its governing body.
2. Nonprofit leaders should devote time and attention to analyzing the changing environment, and steer the organization through those changes.
3. Nonprofit leaders should actively seek to understand underlying causes of mission-related issues and use this awareness to focus organizational activities.



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4. Nonprofit leaders should prioritize organizational goals and negotiate external relationships to buffer against excessive control of the organization by funding sources, government regulators, and other external influences.
5. Nonprofit leaders should recognize and navigate the organization's response to the sometimes competing interests of funders, clients, constituents, the board, the public, and volunteers.
6. Nonprofit leaders should discern a sustainable business model from the organization's size, focus, funding sources, and activities.
12. Nonprofit leaders should create and sustain an organizational culture that best advances the nonprofit's mission and goals.
13. Nonprofit leaders should push the organization to make difficult and timely decisions, challenge others in the organization when necessary, and permit conflicting views to be expressed on the way to reaching resolution.
14. Nonprofit leaders should foster a culture of information sharing and interaction between the board and others in the organization so that innovation and creativity can come from diverse parts of the organization.

Communications

7. Nonprofit leaders should help the organization cope with multiple demands by focusing the organization's attention on timely, mission-relevant issues and opportunities.
8. Leaders should advocate for their organization and its mission, championing the cause in- and outside of the organization.
9. Leaders should actively communicate how the organization's activities produce the intended change in the community and inspire others to effect that change through fundraising, advocacy, and programming.
10. Nonprofit leaders should ensure that sufficient time and energy are invested in the organization's communications capacity.
15. Nonprofit leaders should identify and implement opportunities that enhance a positive work environment.
16. Nonprofit leaders should demonstrate the behaviors they expect of their colleagues.
17. Nonprofit leaders should encourage their organization's staff and board to seek out, recognize, and leverage the shared and different values of diverse cultures.
18. Nonprofit leaders should pay attention and attend to their need for professional and personal renewal and encourage the same in others.
19. Nonprofit leaders should allow for and encourage questions and reflections on the organization's strategies, effectiveness, and ability to change.

Culture

11. Nonprofit leaders should continually develop the skills, knowledge, and abilities of others at all levels of the organization so that they may take on greater responsibility for carrying out the organization's mission and engaging community members.

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The nonprofit world is changing, yet one fact remains: success depends on people.

That's why large nonprofits like National Wildlife Federation, United Ways, and others across the country are empowering their people by switching to StratusLIVE. Break down information silos, promote cross-collaboration, and access real-time data to help your people become better fundraisers.

It's time to empower your people.

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