**The Flap about General Operating Support**

Last year, a group of senior foundation executives, nonprofit management experts and academics—some of the most experienced, thoughtful and engaged people in the philanthropic field—met for a daylong discussion. The room was filled with new and old friends, and the din of spirited conversation among colleagues prevailed. Eventually, the chairman quieted the room and asked a participant to make an opening statement about the topic of the day: general operating support. "Well," said the speaker, "why should anyone give anything else?" The statement was unexpectedly controversial. Debate raged all day over the pros and cons, the wisdom and effectiveness, of making a gift of unrestricted cash to a nonprofit organization.

Visitors from the for-profit business world might have found the whole discussion puzzling (even assuming they understood the phrase "general operating support," sometimes referred to as "unrestricted support" or "core support"). These were important people—busy leaders of major philanthropies. Would the Federal Reserve Bank Board of Governors ever meet for a day to debate "cash" and whether banks should provide it to their customers? Why should this concept be controversial? As with the Federal Reserve and all other banks, the equivalent of general operating support in the for-profit world is simply cash, and it's the rule, not the exception. Cash is provided to for-profit businesses regularly without the buyers of services specifying how it will be used. Bankers and equity investors may add restrictions, but they understand the need for cash within a growing business. In fact, it's well established that one of the most predictable risks for any business is *not* having unrestricted cash when it's needed. And both buyers of products and bankers investing in companies must in the end trust management to produce the desired result, or they typically won't buy, invest or lend. Why the passion in our sector against something so universally embraced on the for-profit side?

As the discussion progressed, it became clear that one reason the concept was controversial was because a significant number of the speakers held inconsistent core assumptions. Some believed that by restricting funds to program, grantees were forced to cut frills, keep costs low and operate frugally. Some felt it was important to control overhead costs and that restrictions were the way to do so. Some felt that restrictions on cash allowed results produced by their dollars to be tracked, and that unrestricted funds would make tracking impossible. Others extended this causal relationship, arguing that many good programs would not have happened were it not for restricted grants. Finally, it was clear that many believed that the nature of the financial transaction itself was secondary, or didn't acknowledge that it was a financial transaction. More important by far was the quality of their personal relationship with grantees. They cited power dynamics, the centrality of establishing trust, solidarity around program goals, and personally adding value as the key

elements of a grantee/grantor relationship. The general impression was that very few in the room understood or even thought about the basics of financial transactions or business dynamics.

Ironically, the day's debate about general operating support was strong evidence that we in the philanthropic and nonprofit fields need to get more comfortable with money, which is, after all, our core business. This doesn't mean getting more businesslike, more resourceful or more efficient, although nobody could reasonably object to these goals. Our sector has a complement of managers who regularly spin straw into gold, know how to squeeze a dollar and work the system to the advantage of their constituents, despite an extremely complex set of challenges.

"Getting more comfortable with money," means working to change the way we do business. There is ample evidence that much of our sector faces the interrelated financial problems of undercapitalization, uneven access to capital, and below-cost pricing for services. But there is little understanding that the *way* we provide financing and funding—including restricting cash—tends to make these problems worse for nonprofits and the people they serve, not better.

One explanation for both the passion of the day's debate about general operating support and the wide range of strongly held opinions is simple lack of knowledge, including blissful ignorance that anything is amiss. Most of us have obediently substituted fixed rules and beliefs about "best practices" for deeper and more nuanced knowledge regarding the financial needs of the complex and diverse businesses we fund and operate. These fixed rules, deeply ingrained and seldom questioned, include venerable adages and superstitions such as "we should restrict overhead to 10 to 15 percent of operating expenses;" "nonprofits shouldn't have surpluses—if they do, they don't need philanthropic money;" "if you restrict your funds, they can go to the important thing—program—which helps reduce waste and allows you to track impact;" "growth is good because it improves program coverage, creates economies of scale and makes organizations more sustainable;" and, of course, "our dollars go only to program—we don't give general operating support."

In practice, these beliefs are almost always wrong. The operating reality is much more complex and challenging than these rules imply. Adverse business conditions include lack of profitability in the core business (mission dictates that we stay in unprofitable businesses; custom often prescribes that we exit profitable ones), growth dynamics where no internal working capital is generated to fund growth costs (you lose a buck on every widget and no, in our sector you do not make it up in volume, either—in fact, you *never* do!), and the prevalence of extensive private and public regulation, including donor restrictions on funds and multiple complex government contracting regulations. These conditions are layered on top of the customary struggles of any growing nonprofit or for-profit business: the need to invest in additional and more sophisticated infrastructure for greater efficiency as growth occurs, the need to make alternative strategic investment decisions in a resource-constrained environment (i.e., buy or lease? Scatter site or centralized delivery? High tech or high touch?), the need to upgrade management skills beyond those of the founder as growth takes place, and so on.

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While this is not news, our supposedly wise rules of thumb make matters worse. Deeply ingrained "best practices" frequently add cost and reduce management flexibility in already difficult operating conditions. We end up hurting organizations we mean to help. And while most of the sector's management improvement and capacity-building work focuses on fixing the management practices of nonprofits themselves, much greater untapped leverage resides in improvement of funding practices, where both funders and nonprofits create broader and more powerful system change. In such a scenario, "capacity building," for example, is not episodic but recognized as an essential part of the cost of programs. And while it's true that foundations provide a relatively small part of the philanthropic pie, their funds are influential, with the power to create impetus in the right direction for individuals and the avowed gorilla on the block, government.

What are some examples of the conditions, beliefs and omissions that fuel the controversy and confusion about general operating support? How might we do better in formal philanthropy and thereby point the way to better practices for the sources of the lion's share of revenue: government and individuals?

Below are three counterintuitive (or rule of thumb-defying) business realities, which, if understood and acted upon, might lead us to quite different kinds of conversations with grantees and, ultimately, quite different kinds of grants. These embrace the points deftly made by Paul Brest in his article, "Smart Money, the Case for Strategic General Operating Support" (*Stanford Innovation Review)* and build on the range of unintended impacts on the capitalization and business needs of organizations in the field**.**

**1. Growth of program makes nonprofits more fragile financially in the near term (as it does with for-profits) and less self-sufficient (more contribution dependent) in the long term.**

It is a surprise that program growth for a nonprofit almost always increases financial fragility in the near term and decreases self-sufficiency in the long term. In recent years, the sector has tended to embrace, or at least reflect, the belief that nonprofits can learn from for-profits, making business ideas such as "going to scale" and "accessing capital markets to fund growth" popular. These ideas are salutary, but they are far from an exact fit with the facts of the nonprofit business world.

In the for-profit world, we assume that growth and scale eventually create profitability, self-sufficiency and, hence, an exit for backers. If this does not occur, the company goes out of business, and investors write off the loss. Investors in successful for-profits can get their initial cash investment out, with a return, as more investors provide dollars and growth proceeds. Two of nonprofits' basic operating tenets run contrary to the full realization of this model.

First, nonprofits often address market imperfections. These imperfections make certain businesses unattractive to the mainstream economy, even in the presence of broadly shared understanding that the activity is socially desirable. Such businesses include providing basic services such as health care, education and housing to people who can't afford them. Second is the issue of nonprofits that provide services that are


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difficult to measure (teaching 5-year-olds, for example), where increasing scale (class size) to improve profitability is problematic for qualitative reasons. Sometimes, both of these market imperfections affect one nonprofit sector—child care for low- and moderate-income parents, for example—making it difficult for these businesses to succeed.

When nonprofit businesses grow, their growth increases the need for subsidy (usually fundraising). This runs contrary to the for-profit expectation that, after an initial period of deficits in start-up or growth, profits will increase. Thus, it’s awkward for funders to expect to be able to exit as a program succeeds and “goes to scale.” In reality, encouraging program-only growth typically increases the size of the nonprofit’s structural deficit in the core (mission-related) business, and therefore increases dependency on contributions for the long haul. A nonprofit overcomes this increase by starting a second business—usually fundraising—so it can fill this continually increasing gap. Major educational institutions, for example, have not improved profitability and sustainability by continually increasing the number of people they serve (undergraduates, say) within their core business (education). They have done so by growing and making more efficient their “subsidy” businesses (contributions from alumni, for example).

**2. Restrictions on grants generally increase cost and risk to grantees’ programs.**

The increases in cost and risk occur in direct proportion to three factors: the degree of restriction (the more restriction, the stronger impact); the grant size relative to the total revenue size of the organization (the larger the proportion, the greater the impact), and the natural illiquidity of the asset that will be affected by the grant (i.e., a restricted grant for a building, which is illiquid, has more cost/risk impact than a restricted grant for program expansion). Restrictions rarely have any positive impact on management or real connection to results.

When funders argue for restrictions on grants, two arguments are common: leverage and control. The leverage argument goes something like this: “Foundation dollars are scarce and a relatively small part of total revenue. We want our dollars to go to something identifiable so we can see the impact of our grant. We also need to leverage other funding and avoid creating dependency (i.e., have an exit strategy), where the program being funded is so promising and identifiable that others will come in after the ‘proof of concept’ stage to fund it for the long term.”

The control argument goes something like this: “We love the work this group is doing, but we need to be sure it is fiscally prudent and that management has the business skills and infrastructure to do the job. When we go to bat for an organization, we are putting our own reputation on the line and that of the foundation and its board. We have a fiduciary duty to assure the board that the foundation’s money isn’t being wasted. Controls on grants help us assuage anxiety that the organization, while promising, isn’t quite up to the task managerially. We can impart discipline to the process and thus provide a valuable service.”

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While these rationales appear to make perfect sense, they are wishful thinking and don't really accomplish what they are meant to accomplish. Restrictions don't improve business skills, lower costs or provide cause-and-effect relationships between inputs and outcomes. All too often, restrictions end up raising costs, lowering efficiency and hollowing out capital structure, undermining the original intent. In essence, they encourage expansion of program while paying only its marginal cost. Even in the instance where the funder adds a nice dollop of "overhead" funding, the funder has only paid the cost of the service from *existing* production capacity (assuming it's been priced appropriately). If a funder wants to fund growth—to both pay for services on behalf of constituents and help the organization expand its ability to serve more constituents (expand the factory) or serve them differently (retool the factory), additional capital costs come into play. If those costs aren't paid, the capital structure and capacity of the organization won't be able to meet the challenge. The usual list of problems—cash-flow crises, deferred maintenance on the building, turnover of staff, downtime for programs, quality problems—follows predictably.

**3. "Overhead rate" and "fundraising cost" are not constant within the sector, they have little or no value as performance or efficiency metrics for most nonprofits, and neither funders nor the public should pay them much attention.**

The universe of nonprofit organizations is extremely diverse relative to its size, so "one size fits few." The direct, everyday experience of grantmakers ranges from funding research at large universities to creating nongovernmental organizations in developing countries to making grants to very small advocacy organizations. Grantmakers within a single program subsector—health, for example—might fund all of these kinds of organizations. This means that most fixed metrics, such as overhead rate and fundraising cost, when applied wholesale are used inappropriately or imprecisely. Therefore, these numbers generally lack real meaning or integrity. Most funders know this but continue to use them, and nonprofit managers are forced to go along. After all, they are time-tested metrics that indicate … well … what *do* they indicate?

Imagine if quarterly corporate reports came out, and the financial press switched from using standard for-profit metrics such as return on assets and profitability to using the most universal nonprofit sector metric, overhead rate. "IBM overhead drops by 3 percent," they report, or "AT&T overhead rate raised!" What would most stockholders do with that information? Similarly, fundraising cost is an imprecise and undependable metric when taken alone. What if a nonprofit's overhead rate were 20 percent, or its fundraising costs 30 percent, but it developed a cure for cancer? Indicators of program quality and progress, along with real business metrics that have substantive meaning to the field, are much more important and useful than these old chestnuts.

Both overhead rate and fundraising cost are much more likely to be indicators of organizational scale, market, nature of the core business and stage of development (start-up, growth, turnaround, maturity, etc.) than of anything the public fundamentally cares about. Growing nonprofits and for-profits alike almost always have elevated administrative costs and overhead rates during periods of growth. They


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invest in, for example, new computer systems, more skilled personnel, training and space in which they can grow while the business catches up. That is how any business improves efficiency as growth occurs.

In the nonprofit sector, however, the elevated overhead rate is much more pronounced since we need to invest in two businesses—the core business (child care, for example) and the subsidy business (fundraising, the dinner dance, or another source of funds not generated through direct services that makes up for the child care business losing money). To maintain financial equilibrium, the subsidy business needs to grow alongside the growing (and money-losing) core business. Thus, wholesale application of these fixed rules for overhead or fundraising cost are especially punishing in our sector, particularly for fast growing, innovative and highly promising organizations. And while foundation funding is a relatively small part of the philanthropic whole, it is prominent in the funding mix of these promising new and growing nonprofits. Because foundations frequently lead the charge in making grants for innovation and new program development, their understanding of the "money rules" is especially important.

Finally, an important unintended effect of the unthinking application of these rules of thumb is to worsen the inequities inherent in access to capital by nonprofits of varying sizes. When applied wholesale, these fixed metrics not only undermine investment in growing organizations, they also worsen the existing imbalance of funding to the largest, wealthiest, most mature institutions —not because of their performance (which may or may not be good) but simply because their size, business type and market segment make their overhead and fundraising percentages seem small by comparison.

## WHY DOES GENERAL OPERATING SUPPORT HELP?

In reality, unrestricted cash, whatever the source, helps. If an organization gets enough unrestricted cash from fees, alumni contributions, interest, or bake sales, some restricted grants are not a problem. If grants of unrestricted cash were the rule rather than the exception, all the problems cited above would be mitigated. But as long as program growth makes organizations more fragile, we shouldn't push managers to grow by restricting grants for program and denying funds to cover the real cost of the growth itself. If restricting grants to a specific asset, such as a building, is policy, we must make sure there will be enough provision for cash elsewhere in the organization to make that new asset accessible and well-programmed—to make it the positive force it can be. And we must no longer rely on overhead rate or fundraising cost to restrict cash in grantees' line item budgets. This practice simply reduces management flexibility and raises internal costs. It doesn't improve efficiency and can reduce effectiveness.

If we must restrict funds, we should restrict them to areas such as infrastructure, overhead, depreciation or debt service. These uses are far more likely to help a promising program grow and succeed than funds restricted to direct program. Leaders and managers of nonprofits don't have to be encouraged to increase funds for and spend more on program. Conversely, they have to be both kept from increasing program beyond their capacity to manage and encouraged to adequately


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fund and pay attention to infrastructure. Squandering program dollars on funding depreciation, for example, has not to my knowledge been a widespread problem and is hardly wasteful. However, it is a very real cost of doing business that, if unfunded, eventually hurts program by resulting in dangerous and decrepit buildings, expensive repairs and interrupted services. Because funds restricted to program expansion are the easiest to raise, the whole sector is skewed toward a financial strategy that undermines operating capacity. Therefore, increasing capacity through a grant to infrastructure is the lowest risk, highest return way to help operators leverage other funds, improve efficiency and, thereby, get the desired result—more, better program.

General operating support provided to further a specific overall strategic or business plan, informed by ongoing program metrics, accomplishes both purposes without restrictions. There may be exceptions: If a funder is making a grant to a small research project in a large institution, for example, earmarking may make sense. But the rule should be general support first, earmarking for general infrastructure and capacity building second (especially if the funder wants program growth), and funds restricted to program a distant third. Beyond that, line-by-line restrictions are expensive, difficult to document, burden an organization's accounting function and generally do not add value.

In short, the form and substance of money within nonprofit businesses—evidenced as capitalization and business dynamics—is in and of itself a powerful contributor to success or failure of mission. The needed changes won't be accomplished by standard management education, "quick fix" management support or capacity building—although again, these are important services to the field. Fundamental, lasting improvement requires a wholesale change in the assumptions that underlie our practice, as well as in the practices themselves, on both sides of the desk.

Reform of our system and wholesale improvements to our practices is urgent. The current environment—privatization and commercialization, technological and market shifts, and government devolution—is challenging and unforgiving. If we are going to be able to meet these challenges, we need to change the way we do business—literally—and do it now.

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