What do you do when traditional sources of funding fall short?

ENTERPRISING NONPROFITS

BY J. GREGORY DEES

LAST AUGUST, the American Medical Association backed out of an exclusive deal with Sunbeam Corporation, a manufacturer of such health-related products as thermometers and blood pressure monitors. The deal would have allowed Sunbeam to display an AMA seal of approval on some of its products – products that would then be packaged with AMA-sponsored health information. In return, Sunbeam would pay a royalty to the AMA on sales of the endorsed products.

The agreement sparked an outcry from the AMA's members and other observers who feared that it would compromise the integrity of the 150-year-old association. The reaction was so strong that the AMA's board of trustees was forced to rescind key terms of the deal just one week after announcing it. The revised policy specified that the association would not endorse products, accept royalties, or enter into exclusive arrangements with corporate partners. Sunbeam would be asked only to distribute the AMA's health information with its products and would pay the association only enough to cover the costs of producing the inserts. The AMA would not profit from the corporate use of its name.

The AMA's experience highlights how turbulent the new tide of commercialization in the nonprofit world can be. Faced with rising costs, more competition for fewer donations and grants, and increased rivalry from for-profit companies entering the social sector, nonprofits are turning to the for-profit world to leverage or replace their traditional

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sources of funding. In addition, leaders of nonprofits look to commercial funding in the belief that market-based revenues can be easier to grow and more resilient than philanthropic funding.

The drive to become more businesslike, however, holds many dangers for nonprofits. In the best of circumstances, nonprofits face operational and cultural challenges in the pursuit of commercial funding. In the worst, commercial operations can undercut an organization's social mission. To explore the new possibilities of commercialization and to avoid its perils, nonprofit leaders need to craft their strategies carefully. A framework – what I call the *social enterprise spectrum* – can help them understand and assess the options they face.

The Rising Tide of Commercialization

Nonprofit organizations have traditionally operated in the so-called social sector to solve or ameliorate such problems as hunger, homelessness, environmental pollution, drug abuse, and domestic violence. They have also provided certain basic social goods – such as education, the arts, and health care – that society believes the marketplace by itself will not adequately supply. Nonprofits have supplemented government activities, contributed ideas for new programs and other innovations, and functioned as vehicles for private citizens to pursue their own visions of the good society independent of government policy. Although some nonprofits have relied heavily on fees – especially those in the fields of health care and education – government grants and private donations have also accounted for a considerable portion of the funding that many nonprofits receive.

Recently, however, an increasing number of nonprofits have been seeking additional revenues by behaving more like for-profit organizations. Some are raising funds through auxiliary commercial enterprises. For example, Save the Children, an international development agency, sells a line of men's neckwear. Such ventures are for the most part bold, creative extensions of the old-fashioned bake sale or car wash: they get the word out about a nonprofit organization and its cause and, if successful, generate cash.

More dramatically, a number of nonprofits are beginning to commercialize the core programs through which they accomplish their missions; that is, they are looking for ways to make these programs rely less on donations and grants and more on fees and contracts. Some are accepting contracts from government agencies, for instance, to run social service programs, schools, and job-training programs for welfare recipients. Others are performing fee-based work for corporations or are charging beneficiaries directly for services that used to be free. For example, universities are engaging in contract research and are forming commercial partnerships to capitalize on the results of their noncontract research. Better Business Bureaus have explored charging a fee for reports on companies. Some nonprofits are even launching business enterprises to serve the objectives of their missions. For instance, San Francisco's Delancy Street Restaurant, run by the Delancy Street Foundation, is staffed by ex-convicts and former substance abusers who participate in Delancy's intensive self-help program and work in the restaurant as part of their rehabilitation. Finally, a few nonprofits, most notably hospitals and health maintenance organizations, are converting to for-profit status or are being acquired by for-profit companies.

A new pro-business zeitgeist has made for-profit initiatives more acceptable in the nonprofit world.

Nonprofit leaders are scrambling to find commercial opportunities for a number of reasons. First, a new pro-business zeitgeist has made for-profit initiatives more acceptable. With the apparent triumph of capitalism worldwide, market forces are being widely celebrated. And with growing confidence in the power of competition and the profit motive to promote efficiency and innovation, many observers are suggesting that market discipline should exert more influence in the social sector – especially when those observers have fundamental doubts about the performance of social enterprises.

Second, many nonprofit leaders are looking to deliver social goods and services in ways that do not create dependency in their constituencies. Even many advocates for the poor or disadvantaged believe that institutional charity can undermine beneficiaries' self-esteem and create a sense of helplessness. As a result, some organizations are charging beneficiaries for at least a portion of the cost of services. Others seek to use business as a tool for helping people develop self-reliance and build marketable capabilities. One important study of nonprofit businesses that help the homeless and other disadvantaged groups become self-sufficient was recently published by Jed Emerson of the Roberts Foundation (now called the Roberts Enterprise Development Fund and originally created by George Roberts of the LBO firm, Kholberg, Kravis, and Roberts). The study documents a host of job-creating nonprofit businesses – such as bakeries, ice cream shops, and greeting-card and silk-screened T-shirt stores – all in the San Francisco Bay Area.

Third, nonprofit leaders are searching for the holy grail of financial sustainability. They view earned-income-generating activities as more reliable funding sources than donations and grants. Many of them now consider extensive dependency on donors as a sign of weakness and vulnerability. Self-funding is the new mantra. At a minimum, organizations seek a diversity of funding sources to provide a cushion in case one source declines or disappears. Commercial funding is particularly attractive because it is potentially unrestricted: owners of a commercial enterprise can use excess revenues for whatever purposes they like, whereas the use of grants and donations to nonprofits is often restricted to particular projects and purposes. Furthermore, commercial markets are potentially huge.

Fourth, the sources of funds available to nonprofits are shifting to favor more commercial approaches. Competition for philanthropic dollars is intense, but money is becoming available for operating on a more commercial basis. Consider the following changes: Today few foundations want to provide ongoing funding – even to highly successful projects. Most choose to limit their funding to short periods in an effort to press grantees to become increasingly self-sufficient. At the same time, government agencies are shifting from providing services themselves to contracting with independent nonprofit and for-profit organizations. Such contracting creates opportunities, but government grant programs are being cut or threatened. Finally, corporations are thinking more strategically about philanthropy. They are no longer deciding where their grant dollars will go solely on the merits of the programs they will fund but on the value they will derive from the relationship with a particular nonprofit. Some corporations are exploring the benefits of direct business relationships with nonprofits, and others have started paying for social services as an employee benefit – again creating new commercial opportunities in the social sector.

Fifth, competitive forces are leading nonprofit managers to consider commercial alternatives to traditional sources of funding. New for-profit companies have made considerable headway in health care and are beginning to enter other social services – such as running orphanages, managing charter schools, and providing welfare-to-work programs. As for-profit companies enter an industry and some nonprofits start experimenting with commercial operations, other nonprofits feel pressured to follow the lead of their competitors that are turning to commercial sources of revenue. For instance, many nonprofit hospitals mimic the management styles and methods of their for-profit counterparts. Similarly, if some major universities subsidize their operations by commercializing research, others will do the same – if only to maintain a competitive cost structure. Once commercialization in a social-sector industry begins, many nonprofits jump on the bandwagon – even if questions remain about how successful those operations ultimately will be.

An increasing number of nonprofits are seeking additional revenues by behaving more like for-profit organizations.

Navigating Dangerous Currents

Market-based funding approaches do have an important role to play in the social sector. If those social programs that are able to generate their own income in fact do so, philanthropic dollars can be allocated to activities that truly need to be subsidized. But embracing commercial opportunities can be risky. The often perilous currents of commercialization in the social sector must be navigated with care. There are a number of dangers that nonprofit leaders should be aware of.

Like the proverbial tail wagging the dog, new sources of revenue can pull an organization away from its original social mission. Consider the YMCA. The association today generates substantial revenues by operating health-and-fitness facilities for middle-class families, but critics charge that the YMCA has lost sight of its mission to promote the "spiritual, mental, and social condition of young men." Similarly, a former board member of a major dance company resigned because he felt the company had neglected its artistic mission and had become too commercial by performing popular pieces to generate revenue. Of course, changing a mission in order to ensure the survival of a worthwhile organization may be justifiable. But nonprofits should be aware that by seizing market opportunities, they may be drawn incrementally and unintentionally into new arenas far from their original focus.

Nonprofit leaders should also recognize that creating a sustainable and profitable business is not easy. Market discipline can be harsh. Some studies indicate that more than 70% of new businesses fail within eight years of their inception. Substantial profits, although not impossible to achieve, are hard to come by. In perfectly competitive markets, companies make only enough to cover costs and to compensate capital providers adequately. Running a profitable business requires skill, luck, and flexibility. Nonprofits may have some advantages when competing in commercial markets. Those advantages include their tax status and their ability to capitalize on volunteer labor, to attract in-kind donations and supplier discounts, and to use philanthropic money to help cover start-up costs and capital investments. But those advantages alone will not ensure profitability.

Many nonprofits simply do not have the business-specific organizational skills, managerial capacity, and credibility to succeed in commercial markets. And building new organizational capabilities can be costly and difficult. Hiring people with business skills and market focus is not enough. An organization must be receptive to and supportive of new activities; it also must be able to integrate the skills and values of the new staff. Many MBAs who go to work in nonprofit organizations find themselves ostracized by their colleagues. One business school graduate and former brand manager at a major corporation, who now heads a division of a nonprofit devoted to environmental protection, spent several years overcoming the skepticism of core staff members. In that organization, scientific credentials and a demonstrated commitment to the environment were signs of prestige; business skills were suspect. The division head's staff feared that he would focus on the bottom line to the exclusion of the mission.

Indeed, the culture of commerce can conflict with that of the social sector in several ways. Many who work in nonprofits are uncomfortable with the style of operations common to for-profit organizations. Consider the conflicts that occurred at a major nongovernmental organization operating in a developing country. On one side were the social workers who were committed to helping their poverty-stricken clientele. On the other side were the loan officers in the newly formed, self-sustaining microloan operation, which helps some of the same clients start small businesses. When the loan officers had to demand payments from a client, the social workers objected. They found this kind of businesslike behavior offensive; it ran counter to their sense of compassion. Although nonprofits have become more accepting of business in general, some nonprofit managers still bristle at the use of business language. Even the word *customer* can put people off. The leader of one community-based arts organization, uncomfortable with the idea of being customer driven, contends that her mission is to provide a forum for avant-garde African-American playwrights, not to cater to the tastes of a local audience. And she is far from unique. Social workers, curators, educators, doctors, nurses, artists, scientists, and other professionals who staff nonprofits may balk when they are expected to adapt more to businesslike methods of operation.

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Commercialization can also undermine the role a nonprofit organization plays in its community. Community-based nonprofits often serve as outlets for citizens to act on their philanthropic impulses – to join voluntarily in efforts to improve the conditions of their community. The executive director of a major food bank believes that the mission of his organization is not only to supply food for the needy but also to provide opportunities for people from all walks of life to volunteer, to serve the poor, and to interact with one another. Volunteers may not be so ready to contribute their time to for-profit programs. Although commercialization need not drive out philanthropic activities, the two impulses can be difficult to balance.

When nonprofits become more businesslike, they may run afoul of public values and meet with political resistance. For instance, the Red Cross blood-bank system has come under attack recently for its attempt to create a national system of distribution, its allegedly aggressive pursuit of donors, and its alleged failure to serve hospitals that favor other blood providers. Of course, the Red Cross has defended itself against those charges, but the point is that nonprofits are not expected to behave like businesses. When they do, critics are ready to pounce.

Nonprofits that undertake commercial initiatives also face resistance from for-profit competitors. Nonprofits are perceived to have the unfair advantages of tax breaks and lower costs for labor, capital, and supplies. Cross-sector competition exists in industries from day care to publishing to gift catalogs. For-profit providers of adult education services complain about nonprofit rivals. Local retailers don't like competing with university-owned stores that sell not only textbooks but also clothing, computers, records – items that have little to do with a school's educational mission. If the competition continues to heat up, for-profit rivals will step up the pressure for a reconsideration of the tax exemptions offered to nonprofits.

Charting a Favorable Course

Despite the risks of commercialization, nonprofit leaders can chart a favorable course through commercial waters in their search for ways both

THE SOCIAL ENTERPRISE SPECTRUM

		Purely Philanthropic	⟷	Purely Commercial
Motives, Methods, and Goals		Appeal to goodwill Mission driven Social value	Mixed motives Mission and market driven Social and economic value	Appeal to self-interest Market driven Economic value
Key Stakeholders	Beneficiaries	Pay nothing	Subsidized rates, or mix of full payers and those who pay nothing	Market-rate prices
Key Stakeholders	Capital	Donations and grants	Below-market capital, or mix of donations and market-rate capital	Market-rate capital
Key Stakeholders	Workforces	Volunteers	Below-market wages, or mix of volunteers and fully paid staff	Market-rate compensation
Key Stakeholders	Suppliers	Make in-kind donations	Special discounts, or mix of in-kind and full-price donations	Market-rate prices

to reduce their organizations' dependence on grants and to enhance their mission-related performance. The challenge is to find a financial structure that reinforces the organization's mission, uses scarce resources efficiently, is responsive to changes, and is practically achievable.

To begin, nonprofit leaders must understand the full range of available options. A social enterprise is commercial to the extent that it operates like a business in how it acquires its resources and distributes its goods and services. The more commercial an organization, the less it relies on philanthropy. Few social enterprises can or should be purely philanthropic or purely commercial; most should combine commercial and philanthropic elements in a productive balance. Many already do. (See the exhibit "The Social Enterprise Spectrum," which shows the range of commercialization in terms of a nonprofit's relationships with its key stakeholders.)

For instance, colleges and universities charge a tuition that does not cover operating costs because such institutions can draw on alumni donations, research grants, and income from endowments. Some nonprofits cross-subsidize one program or client group with another. Many day care centers use a sliding fee scale so that wealthier families subsidize poorer ones. Ballet companies often use profits from holiday performances of the *Nutcracker* to support artistically important but unprofitable productions. Still other nonprofits obtain funding from third-party payers, such as governments and corporations. Health care providers commonly receive the bulk of their revenues from public and private insurance plans. Social service providers can contract with state government agencies to provide their services to state residents.

As they evaluate their organizations' potential to operate at the commercial end of the spectrum, nonprofit leaders should begin by identifying all potential commercial sources of revenue. Potential paying customers include the organization's intended beneficiaries, third parties with a vested interest in the mission, and others for whom the organization can create value.

Earned Income from Intended Beneficiaries. In an ideal world, social enterprises would receive funding and attract resources only when they produced their intended social impact – such as alleviating poverty in a given area, reducing drug abuse, delivering high-quality education, or conserving natural resources. The best strategy in this ideal world would be to ask the intended beneficiaries to pay full cost for services. After all, the beneficiary would be in a prime position to determine if the value created was sufficiently high to justify the costs of creating it. In the real world, however, this approach works only for nonprofits that are in the business of serving a clearly defined and well-informed consumer who is able to pay. Membership organizations are one example; their beneficiaries, or members, pay for services through membership fees.

Few nonprofits will be able to reduce their missions to that kind of formula. The intended beneficiaries of a social enterprise are rarely well-informed, viable, or appropriate payers. In some instances, it isn't even clear who the intended beneficiaries are. Who is the intended beneficiary of a project to save the whales from extinction? The whales? The general public? Future generations? In many social enterprises, the intended beneficiary is unable to pay anything close to the cost of the services delivered. For instance, if development agencies such as CARE, Save the Children, and Oxfam – agencies that serve poor, distressed communities – relied exclusively on fees charged to residents, they would be able to operate only in relatively wealthy communities.

In other instances, beneficiaries may not be sufficiently knowledgeable to make an informed purchase decision. Or they may not fully appreciate the value of the service being offered. For example, abusive spouses who recognize that they have a problem but underestimate its severity might not realize the benefit of counseling to themselves and to their families until after they have gone through a program. If full payment were required, they might not undergo counseling at all. Because collective goods are often at stake in the work of nonprofits, society might lose in such an exchange as well. For example, society benefits from the drop in crime rates that occurs if addicts are treated in rehabilitation programs; but if addicts were required to pay the full cost of the program, few would join.

Finally, requiring intended beneficiaries to pay may be inappropriate, even when it is feasible. Commercialization can often change the character of a nonprofit's relationship with its beneficiaries. Imagine Amnesty International charging a fee to the political prisoners who are released as a result of its activities or the Red Cross charging disaster victims for relief services. If Big Brothers and Big Sisters charged children or their families for a mentor's time, wouldn't the child suspect that the mentor was there simply for the pay, and wouldn't that suspicion undermine the relationship?

To understand the full range of commercial options, nonprofit leaders should evaluate potential revenues for all beneficiary groups, services, and products. Assumptions about the viability and appropriateness of charging for services also should be explored and questioned. For instance, should a group that serves people with disabilities assume that its constituency could not or should not pay for any of the services it provides? In fact, it can be demeaning to treat people with disabilities as charity cases. Asking for at least some payment can give beneficiaries a sense of responsibility and enhance their commitment to the treatment. In programs requiring the active participation of beneficiaries, pricing serves to screen out those who are not sufficiently serious about the program. If the intended beneficiaries vary in their ability to pay, nonprofit leaders should examine the feasibility and desirability of cross-subsidization and discounted fees. The organization could use sliding fee scales, scholarships, special discounts, and other devices to allow access to people of lesser means. It could also opt for deferred payments along the lines of student loans for higher education. A more radical alternative to deferred payments would be to encourage prepayment or group payment using membership fees or an insurance scheme. Some colleges already offer to guarantee tuition rates many years into the future if parents pay tuition in advance.

Commercialization can often change the character of a nonprofit's relationship with its beneficiaries.

Earned Income from Third-Party Payers with a Vested Interest. Faced with the difficulties of charging intended beneficiaries for services rendered, social enterprises often need to search for next-best solutions. To that end, nonprofits can look to third-party funding sources. The most likely direct payers are government agencies and corporations that have a vested interest in an intended beneficiary group or in the enterprise's mission. The government's role as a source of revenue for certain nonprofit organizations is widely recognized. It has a vested interest in collective goods and in the welfare of the poor. Corporations play a similar role when they subsidize such employee benefits as health care, day care, elder care, family counseling, and alcohol and drug rehabilitation.

Third-party payment can take many forms. The payers can issue vouchers to be used at the discretion of the beneficiary, can reimburse for services chosen by beneficiaries, or can contract directly for service delivery. Contracting itself can range from cost plus to flat rates per capita. In many cases, the beneficiaries share some of the costs through co-payments and deductibles. This approach appealed to the founders of GuateSalud, a health maintenance organization for the rural working poor in Guatemala. After struggling to raise donations for their work, the founders decided to market their health services to the owners of small coffee plantations who employ poor migrant workers during the harvest season. The owners paid a monthly fee for the service, and workers paid token fees for visits to the health facility and for pharmaceuticals. The arrangement was a success: the owners got a healthier workforce, and the workers gained access to medical care and health education that otherwise would not have been available to them.

Nonprofit leaders considering this option need to ask how closely the interests of third-party payers align with the organization's mission. If the interests diverge from the mission now or in the future, how can the mission be protected? The challenge nonprofit leaders face, then, is to find third parties whose interests fit the enterprise's mission and to maximize that alignment. They need to conduct a thorough, fact-based assessment to determine the impact of potential arrangements on the mission. For instance, if it is important for GuateSalud to improve the overall health of poor native

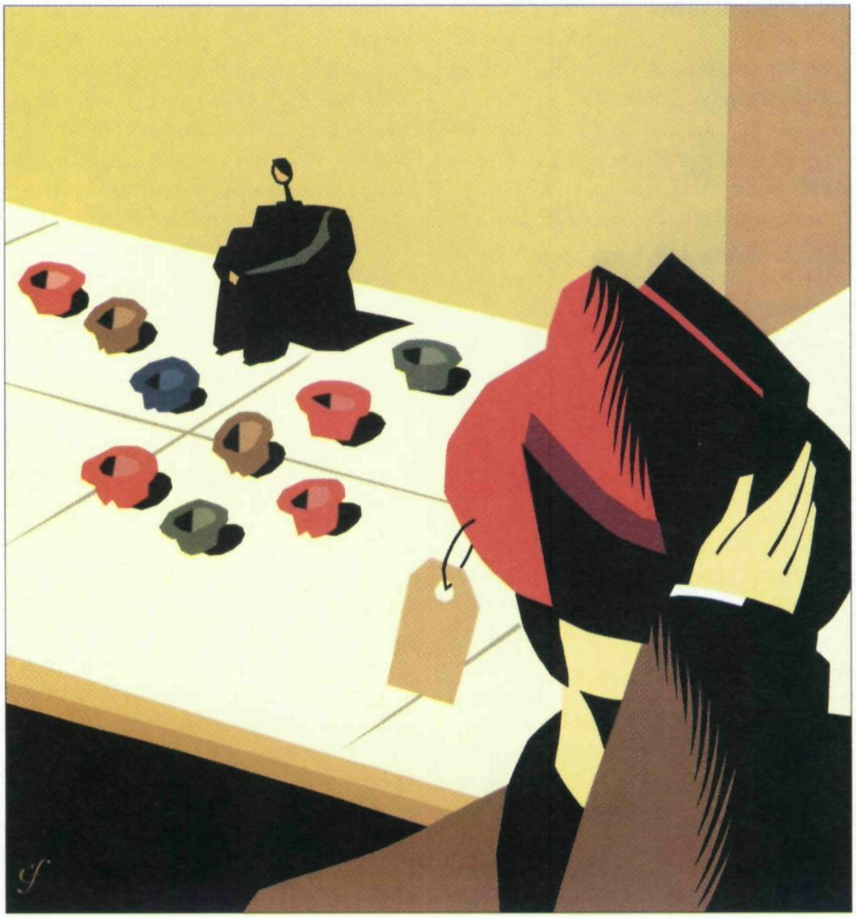
Guatemalans, is contracting with the plantation owners, who have access to many of those workers only during harvest, enough? The answer to that question depends in large part on whether a brief health intervention at harvest time makes a significant difference in health outcomes. The question also must be weighed in the context of alternatives: if funding isn't available for a more substantial intervention, such as placing clinics in remote regions or having health providers travel extensively, contracting with the owners may be better than nothing.

As they conduct their assessment, nonprofit leaders should also consider such practical matters as the costs of negotiating contracts and managing the ongoing relationship with a third-party payer. In some cases, particularly in the case of government contracting, the nonprofit can incur considerable incremental administrative costs.

Finally, nonprofit leaders should evaluate how reliable the revenue stream will be over time. It can be risky for a nonprofit to have just one or a few major payers because a canceled contract would be a major blow to the organization. For instance, Leeway, a nursing home for people with AIDS, depends heavily on Connecticut Medicaid reimbursements. A change in state policy could prevent Leeway from fulfilling its mission. A single funding source may be the best available to an organization such as Leeway, but leaders need to consider the associated risks. Changing funding sources can be quite disruptive and can require a great deal of management time. Yet, some disruptions may be necessary, considering that the alternative – philanthropic fund-raising – is also very time consuming and uncertain.

Earned Income from Others. In addition to obtaining direct payments for mission-related services, nonprofits can receive indirect sources of earned income from third parties. One common form of indirect commercial support is advertising. Corporations may pay for the right to promote their products to a nonprofit's target market. For instance, companies that make baby products might sponsor an educational program for mothers of low-birth-weight infants. So-called cause-related marketing, in which a company uses its support of a nonprofit cause in its promotions, is an extension of this idea. In addition, nonprofits can use their name recognition to *co-brand* products, such as pain relievers endorsed by the Arthritis Foundation. Businesses and individuals also can indirectly support social enterprises by purchasing goods and services. Local hotels and hospitals might contract for services from a commercial laundry operated by a homeless shelter to provide job training and income to residents. In such a case, the third parties are paying the shelter not to provide training for homeless people but to provide laundry services; in other words, they are paying the shelter indirectly to serve its primary constituency.

Finding indirect sources of revenue often requires creativity. Nonprofit leaders should ask themselves how their organizations could create value for someone who would pay. Because this source of earned income is the one least directly related to mission performance, it can risk pulling the organization off course by diverting valuable management resources away from activities related to the organization's core mission. As a result, leaders need to be particularly careful to question the appropriateness of this kind of financial relationship. Will the demands of running a competitive commercial laundry create pressure to employ only shelter residents who already have good job skills, those least in need of training? When corporations with vested interests pay for research, will universities shift resources from basic science to more



Some nonprofits raise funds through auxiliary commercial enterprises; others launch businesses to serve the objectives of their missions.

applied areas? Will they become scientific advocates for the interests of their paying clients?

Choosing the Right Vessel

Once nonprofits identify potential sources of earned income, they should set clear and realistic financial objectives. Commercial programs don't need to be profitable to be worthwhile. They can improve the efficiency and effectiveness of the organization by reducing the need for donated funds, by providing a more reliable, diversified funding base, or by enhancing the quality of programs by instilling market discipline. Following are the possible financial approaches that a nonprofit might adopt. They move roughly from left to right on the social enterprise spectrum.

Full Philanthropic Support. After reviewing their options, the leaders of a nonprofit might decide that no potential sources of earned income are appealing, given the organization's mission and values. They must then decide on the right mixture of philanthropic sources: cash donations, in-kind donations, and volunteer labor. Very few nonprofits will be staffed solely by volunteers and will acquire all their equipment, facilities, and supplies as in-kind donations. For most organizations, cash donations provide a way to adopt more commercial labor and purchasing practices. For instance, a mentoring program for disadvantaged youth could have a paid staff, volunteer adult mentors, some in-kind donations, and a variety of cash operating expenses, and could rely exclusively on grants and donations to cover all out-of-pocket costs. Many new and small social-service nonprofits operate this way, with negligible or no earned income.

Partial Self-Sufficiency. Other nonprofits might conclude that the sources of earned income available to them will cover only part of their necessary operating expenses, even when taking into account potential in-kind donations and volunteer labor. They will need cash donations to pay for some out-of-pocket operating expenses, as well as for start-up costs and capital investments. Most institutions of higher education operate this way. Tuition covers only a portion of total costs; donors subsidize the rest. The difficulty such organizations face is determining the right level of subsidy. To determine that level, they must assess not only potential commercial and philanthropic revenues but also competitive dynamics, values, and mission-related objectives.

For example, Berea College in Berea, Kentucky, targets financially needy Appalachian students and charges no tuition. All students work, but the college covers its costs largely through income from a sizable endowment and annual giving. In contrast, Vermont's Bennington College decided from the start that it did not want to be beholden to donors who might interfere with its mission. (Bennington was founded as an experimental college for women and emphasized individualized, nontraditional courses of study.) The college did not run annual fund-raising campaigns and built a negligible endowment. Instead, it charged a high tuition; in fact, its tuition was frequently one of the highest in the nation.

Nonprofits should keep in mind that commercial programs don't need to be profitable to be worthwhile.

Both schools have long delivered high-quality education. So which model is best? The answer to that question depends both on how well the model serves the institution's mission and on the model's feasibility for sustaining its institution. Bennington's model would not have worked for Berea's mission serving the Appalachian poor. For a time in the 1980s and early 1990s, it did not work very well for Bennington's mission either. High costs and competition for students made the pay-as-you-go model difficult to maintain. The college recently restructured and has launched a capital campaign to build an endowment, but Bennington will not need an endowment as large as Berea's.

Cash Flow Self-Sufficiency. Many nonprofit social enterprises want commercial revenues but not market-based costs. They use earned income to cover out-of-pocket operating expenses, but the costs they incur are lower than market rates because of their ready access to philanthropic investment capital (such as grants and below-market program-related investments made by foundations), volunteers (or below-market wages), and in-kind donations (or discounts). Such organizations are technically self-funding and may even generate excess cash to cover the costs of strapped mission-related activities, but they still depend on noncash philanthropic subsidies.

Help the World See (HTWS) and the new permanent eye-care clinics it has established in developing countries illustrate how this model works. When HTWS began, it sent volunteer doctors with donated glasses to developing countries to set up temporary clinics. Then five years ago, the organization embarked on a new strategy. It would establish permanent clinics, offering affordable ongoing eye care, that would operate self-sufficiently on a cash-flow basis. Start-up capital would be donated; in-kind space would be provided by governments or sympathetic nongovernmental organizations; materials to produce glasses would be acquired at a discount from willing suppliers; and staff training would be covered by grants. But the organization would pay the staff and cover out-of-pocket operating expenses by charging a small fee for glasses. The new strategy demanded a trade-off: the stand-alone clinics would not be able to serve – at least not initially – the very poorest residents, who could not afford even the small fee for glasses. (It was hoped that one day the clinics would be able to generate a "profit" to pay for services for the very poor.) But the clinics could still serve many who were not able to find or afford glasses any other way.

Operating Expense Self-Sufficiency. Nonprofits may be able to have earned income cover all operating expenses, even if those expenses are at market rates. They might obtain donations or below-market loans to cover some start-up expenses and capital expenditures, but after that, the operation would stand on its own without relying on additional philanthropy of any kind, including volunteer and in-kind donations. Few social ventures launched by nonprofits can aspire to this degree of independence from philanthropic support when it comes to operations. One example of a nonprofit organization that has adopted this model is the Kentucky Highlands Investment Corporation. It began with nearly $15 million in grants from the federal government to use as venture capital to stimulate economic development in several distressed counties in southeastern Kentucky. Using returns from its investments, the corporation has been able to cover its operating costs for the venture fund and to make new investments – in the process preserving the value of the fund.

Even when operating self-sufficiency is the goal, most new ventures will need some form of cash subsidy during the start-up period. But nonprofit leaders must decide how long to subsidize the venture. Cutting one's losses in mission-related operations can be difficult: when a new program cannot stand on its own, a nonprofit may have to decide whether to continue the program even though it will need to be subsidized. Shutting down a program may have political costs or an unfortunate impact on an organization's mission. For instance, the Bangladesh Rural Advancement Committee (BRAC) created a silk industry from scratch in Bangladesh to employ women and the landless poor. BRAC intended for all parts of the industry's value chain – from growing mulberry trees to selling the products made with BRAC silk – to operate self-sufficiently. But the silk-reeling plants were very inefficient, in large part because of the inherently poor quality of the cocoons that were bred to grow in Bangladesh. To pay its workers a living wage, BRAC had to accept losses on this stage in the production process. Shutting down the plants would have crippled the entire silk project, hurting thousands of workers and strengthening the hand of BRAC's fundamentalist political opponents. BRAC intends to work to make the plants profitable, but it will be difficult to pull the plug on this operation even if profitability is never achieved.

Full-Scale Commercialization. When an organization is fully commercial, revenue covers all costs at market rates, including the market cost of capital, without a hint of philanthropic subsidy even for start-up expenses. The organization repays start-up capital at a market rate of return and is sufficiently profitable to attract new investment capital for expansion. Few nonprofits can achieve full-scale commercialization. Because nonprofits cannot accept equity investments and it is difficult to be financed totally with debt, such organizations often are structured as, or convert to, for-profit enterprises.

Nonprofits that are this strongly committed to commercialization – and to their independence from philanthropic subsidies – face a challenging balancing act. On the one hand, they will need to act like businesses by preserving their flexibility and by being willing to cut losses and search for new sources of revenue. On the other hand, they will have to do so within the constraints of their mission. Absent a philanthropic cushion and a commitment to philanthropic supporters, nonprofit leaders will need to keep the enterprise's mission in mind when reacting to business pressures.

Mixed Enterprises. Finally, it should be noted that many social enterprises are actually multi-unit operations that run programs with different financial objectives and funding structures. A major museum might have both a profitable catalog business and a highly subsidized research-and-acquisition operation. The Nature Conservancy established a for-profit company, the Eastern Shore Sustainable Development Corporation, in order to generate profits and create jobs while protecting the environment. The conservancy has partnered with for-profit companies such as Georgia Pacific to find profitable ways to conserve natural habitats, and it offers ecological travel programs for a fee to its members. Yet many of its core conservation activities still rely heavily on donations. (See the insert "Related Readings.")

Other multi-unit social enterprises are for-profit organizations with nonprofit affiliates. Shorebank Corporation, for instance, is a development bank with a social mission. It has commercial-banking and real estate operations, as well as an affiliate nonprofit community-development corporation that is dependent on grants. The corporation as a whole has benefited from obtaining program-related capital investments at below-market rates from foundations but otherwise has very commercial methods of operation.

The Skills Needed to Sail Commercial Waters

If nonprofits are to explore commercial options, it is essential both that they build business capabilities and that they manage organizational culture. Management skills are important for all nonprofit organizations, but commercialization calls for expertise, knowledge, and attitudes more commonly found in the business world. Nonprofit managers need to become trained in business methods if they are to explore commercial options effectively. One way to gain such training is to reach out for help. Nonprofit managers can begin in their own backyards by finding more effective ways to draw on board members with relevant business experience. The resulting exchange will be a learning experience for both parties. Business board members are often an underutilized source of management expertise, and they need coaching and coaxing to adapt their business frameworks to the context of a social enterprise. They must understand the risks of becoming too businesslike and of moving too quickly. Nonprofit leaders also can reach out for pro bono consulting from volunteer businesspeople or from business school students. And nonprofits exploring commercialization can form alliances with for-profit companies to provide complementary skills and training in business methods.

In the end, for-profit operations will not – and should not – drive out philanthropic initiatives.

Without internal staff expertise, however, the advice of board members, consultants, and partners may not be worth much. The organization needs staff that can understand and implement the new agenda. Organizations can hire employees with business skills, but they will need to address the cultural conflicts and compensation problems that could arise. The new hires must be supported fully, and care must be taken to allow them to build credibility within the core culture. Nonprofit leaders should anticipate cultural conflict and find ways to turn such conflict into a healthy, creative tension. They need to identify where operating styles are likely to clash, and they may have to launch internal education and communications initiatives in order to minimize the harmful effects of conflict and to help staff members agree on appropriate operating styles.

Of course, nonprofit leaders could opt to segregate commercial activities from philanthropic operations. Such an approach should reduce conflict, provided that the separate units do not need to interact on a day-to-day basis. Even so, staff on the more philanthropic side of operations may view their commercial colleagues with animosity or envy. Compensation is one possible source of friction between the two cultures. New hires from the business world may require higher compensation than internal staff members with comparable levels of education and years of experience. Pay equity has to be dealt with explicitly, or it will fester.

A former Wall Street banker who now heads a major international economic-development organization is grappling with precisely this issue. His operations have become increasingly sophisticated and require skills typically held by MBA graduates who could land investment-banking jobs. But he cannot pay anything approaching the investment-banking salaries to acquire the talent he needs. It was a challenge to get his board to let him make offers at salaries less than half those that qualified candidates could command in mainstream financial institutions. Yet even those salaries were well above existing wages in the organization, and the leader was concerned about pay equity with the organization's current staff. Raising everyone's salary could be extremely costly. Not doing so could undermine morale.

Engineering a new culture is never easy or quick. Building internal expertise has to be a deliberate strategic process. It cannot be accomplished overnight. Managers must create a new culture that blends commercial values with the traditional philanthropic principles that drive the organization. At the same time, they must work with key stakeholders to build understanding of and support for commercial activities, or they may find themselves in the awkward position that the AMA faced in its deal with Sunbeam.

Nonprofit leaders also need to get legal and tax advice before launching any commercial activities. Unfortunately, tax laws often lag behind industry developments. It is not always clear how current Internal Revenue Service regulations will treat new hybrid forms of organizations. In some cases, it will be better to set up a for-profit subsidiary and pay the appropriate taxes. As the boundaries between nonprofit and for-profit organizations fade, pressure will mount for new regulations and possible revisions in the tax code. Becoming more commercial has political risks and puts the burden of proof on social entrepreneurs to show that their organizations are serving social missions that justify continued tax exemption.

Steering into New Seas

Thoughtful innovation in the social sector is essential if organizations are to leverage limited philanthropic resources. Nonprofit leaders can benefit from finding effective ways to harness commercial forces for social good. But misguided efforts to reinvent nonprofits in the image of business can go wrong. Nonprofit managers are only beginning to learn what it means to search for new solutions to social problems and for more effective ways to deliver socially important goods.

Strategic and structural innovation should focus on improving mission-related performance. Caught up in the current wave of commercialization, nonprofits risk forgetting that the most important measure of success is the achievement of mission-related objectives, not the financial wealth or stability of the organization. The benefit of finding attractive sources of earned income lies more in the leverage this income provides than its sustainability. But generating more funds for ineffective or inefficient programs is not a productive use of resources. True social-sector entrepreneurs are those who find not only additional sources of funds but also new methods to link funding to performance. More important, they develop more effective ways to improve conditions on this planet. To that end, social entrepreneurs shouldn't focus on commercial approaches alone but should explore all strategic options along the social enterprise spectrum, including their ability to use social causes to tap into philanthropic motivations. In fact, multi-unit operations may well be the wave of the future because they recognize and, when it makes sense, utilize a full range of options on the social enterprise spectrum.

In the end, commercial operations will not – and should not – drive out philanthropic initiatives. Many worthwhile objectives cannot effectively be pursued by relying on market mechanisms alone. In any case, people tend to get something out of giving that they cannot get out of market transactions. People want to make contributions to the common good, or to their vision of it. The challenge is to harness these social impulses and marry them to the best aspects of business practice in order to create a social sector that is as effective as it can be.

The author would like to thank Elaine Backman for her contributions to the development of the social enterprise spectrum.

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