
Rationale and Recommendations for Full Cost Contracting

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SUMMARY

QUESTION: WHAT CAN NEW YORK CITY DO TO MAKE OPERATING NONPROFIT SERVICE PROVIDERS MORE STABLE AND VIABLE?

WHY IMPORTANT:

1. *Nonprofit contractors play a significant role in the delivery of critical social services. Contracting nonprofit organizations at full cost will allow operators to develop sustainable and predictable income-generating strategies resulting in an overall economic improvement.*
 2. *Nonprofits are mostly operated by women of color. Empowering nonprofits would generally improve the city's economic position as it would involve more women of color in the economic cycle. Moreover, women of color generally experience intersectionality of discrimination based on their race and gender. Full contracting will also play a crucial role in offering opportunities for the racially discriminated.*
 3. *Nonprofits generally foster strong community relationships, which have numerous advantages to the entire community, including reduced insecurity and crime. The main purpose of nonprofits is to facilitate compassion and foster dignity for everyone. The cost-deficit contracting typically reduces their capacity to achieve this objective. Nonprofits play a significant role in improving the community's resilience and fortitude as it generally offers support systems through its initiatives and programs.*
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RECOMMENDATIONS:

1. *Mandate true cost of living rates in government contracts*
2. *Make the cost of contract administration cheaper—for both the city and the nonprofits--and free up some of that administrative funding to go to providing services*



3. *New York City government explore fixed amount contracts, which is described in the Office of Management and Budget guidance update noted in Section 200.45, which explicitly allows for fixed amount awards as a contracting option from federal agencies.*

CONSTRAINTS:

1. *The divergent and competing objectives of the New York City government.*
2. *A significant portion of the budget is allocated to other competing sectors, which leaves limited funding for service delivery.*
3. *Financing policies that can be utilized to improve the service offered can only be undertaken by federal action or federal bodies; hence it is not within the New York City government's exclusive control.*

INTRODUCTION

The New York City government is mandated to provide critical social safety net services to city residents. The City's government relies on nonprofits to provide nearly all of these services, from feeding those who were made food-insecure during the COVID-19 pandemic to providing safe shelter to those experiencing homelessness. So, while nonprofits and government are partners in addressing critical and needed services for families and individuals in New York, the City's current contracting practices can cause harm to the communities and the nonprofit workforce that serves them. Nonprofits need equitable, fair contracts and adequate funding to cover the costs of providing critical services that all New York City residents rely on for themselves and their neighbors.

In contrast to how they pay for-profit entities, many current city contracts pay nonprofits less than what it costs them to provide services. This practice of paying at cost-deficit rates is one of the most damaging contracting practices in place today. In addition, the onerous compliance requirements of most contracts add costs to providing services, making it less likely that smaller organizations that are deeply connected to the community will seek to contract directly with government payors.

These contracting practices can destabilize the nonprofit workforce, comprising mostly women of color living in the communities they serve, by making them pay the price of complex and inadequate contracts through unfunded labor and, at times,



poverty-level wages. These practices can also destabilize the community the nonprofit is serving due to the program and service interruptions that, despite best efforts, often result. And, the funding gap routinely left by government contracts is only partially covered by private fundraising and other nonprofit revenue streams.

Government needs to pay the full cost of delivering the critical services they are responsible for as part of its promise to the public. Included in the full cost are the costs associated with complying with inflexible and complicated contracting requirements.

Even better, government can immediately move closer to covering full costs by implementing two administrative changes to contract practices that, when combined, will not require more money:

1. Make contracts more flexible and supportive of living wages.
2. Make the cost of contract administration cheaper — for both the city and the nonprofits — and free up some of that administrative funding to go to providing services.

Supporting living wages will result in a more stable workforce. Loosening contract restrictions and reducing bureaucratic processes will enable nonprofit managers to shift more dollars toward direct services. Nonprofits who work closely with communities will be able to adjust services based on knowledge of what is needed and experience with the individuals in their neighborhoods, rather than being locked into potentially outdated contractual commitments/terms. This will result in stronger programs and better outcomes.

METHODOLOGY

Authors Jina Paik and Deirdre Flynn drew from the collective experience of Nonprofit Finance Fund's staff working one-on-one with nonprofit organizations in New York City. This was supported by a literature review conducted by Anna Quinn.

ISSUE CONTEXT

Nonprofits need fair and adequate funding to cover the costs of providing critical services, including an indirect rate that adequately covers costs not directly associated with service delivery. Breaking even is never enough.



Nonprofit organizations play a crucial role in the health, education, and vibrancy of their communities. They form part of the backbone of neighborhoods across New York City, stabilizing main street, employing locally, and providing much-needed services to their communities. Unsurprisingly, they have similar financial needs to those of their for-profit counterparts. Like any small business, they must be able to cover both the total cost of today's operations, like rent, program supplies, etc., and be able to set aside funding to pay for investments needed to sustainably achieve outcomes and deliver on mission over the longer term.

The cost of providing these critically needed services has multiple levels. There are the:

- **Direct program costs:** these are the costs of providing services directly to clients which often includes employee salaries or program supplies.
- **Support costs:** Sometimes called “overhead” or “indirect” costs and only partially covered by contract funding, support costs are somewhat visible like the rent paid on the facility where services are provided or the salary of the person who sits at the reception desk. Importantly, support costs also encompass invisible expenses like supervision of front-line staff, documentation of the services rendered, interest expense on working capital loans to cover delays in reimbursement or financial accounting for the business.
- **Unfunded expense:** These are the costs often unseen in a budget and associated with the work arounds or time spent on unfunded mandates. Prevalent in most of the nonprofit sector, unfunded expenses are often at the heart of staff burnout and financial stress. This might include unfunded and sometimes unpaid staff time to deliver programs or satisfy program requirements or asking staff to provide their own computers for remote work.

In addition to day-to-day operating expenses, nonprofits need to be able to budget and manage to annual surpluses so that they are able to meet their short- and long-term needs, and funders of nonprofits need to understand that breaking even is never enough.

The standard business needs those surpluses help to address include:

- **Weathering disruptions:** Operating without a safety net is not a good business practice. During the COVID-19 shutdown, those with reserves were able to pay for unbudgeted equipment and personal protective equipment needed to keep their staff safe and operations running minimally. However, in 2020, as witnessed in previous downturns, nonprofit organizations without reserves faced greater risk of closure or service interruption, and 23% of nonprofit survey respondents reported considering mergers, compared to 1% in an average year.



- **Adjusting operations:** As the pandemic has shown us, businesses need to pivot when the operating environment changes. For example, many behavioral health providers were required to pivot to telehealth to continue to offer clients the support needed.
- **Repaying debt:** This is particularly important in organizations that rely on government contracts, given delays in reimbursement which often necessitate a working capital loan to cover the cash shortfall.
- **Upgrading facilities and equipment:** Increasingly, nonprofits are being asked to demonstrate outcomes, which is impossible to do without systems to track the needed data.

In order for nonprofits to provide critical services, particularly during moments of community crisis and change, they must be able to support their workforce and manage stable operations. Current contract practices, particularly the practice of intentionally paying nonprofits less than what it costs them to provide services, restrict nonprofits' abilities to provide living wages to their workforce or cover the crucial business needs of running their organization and providing critically needed services to the community.

Nonprofits, as a whole, often feel they have no choice but to accept damaging contract terms because of their dedication to serving the public even if these contracts threaten the stability of the entire organization. With every new RFP that promises pay at a cost-deficit rate, organization leaders must take a gamble about how much of their costs they can truly cover. Managers are often weighing their own financial stability with the need to serve the increasing demand of their communities. When there is a gap in costs, both the stability of the organization and the individuals working within it are jeopardized. The role of indirect funding is key to making contracts minimally functional for nonprofit organizations, and it often represents in excess of 20% of direct program costs.

ISSUES IN CURRENT PRACTICE

1. Government is balancing its budget on the backs of the nonprofit employees, many of whom are women of color.

The nonprofit sector today is 9% of New York City's GDP, employs different kinds of professionals, and supports families and the neighborhood economy through its services and its workforce. The workforce of human services organizations is largely



not unionized, meaning that collective advocacy for fair wages and working conditions has not been consistently mobilized.

Government has been asking the nonprofit community, often already working for below-market wages, to subsidize contracted programs through sweat equity (working unpaid hours) and personal sacrifice. Average wages in the social assistance sector were \$32,733 in 2018, making the sector the second lowest paid in the city after restaurants. The City's poverty threshold that year was \$35,044 for a two-adult, two-child family. Historically, contracted salaries have been significantly lower than direct-hire salaries for similar roles; a 2019 City commitment to salary parity in the early childhood education sector required raising nonprofit wages by more than 40% to reach parity with direct-hire counterparts. The greatest inequity is found in organizations led by and/or serving communities of color. These organizations are often tapped by larger nonprofits as sub-contractors for their expertise "on the ground" but are often ineligible to apply for or able to support the added (and often hidden) cost of complying with the requirements of a government contract. In addition, the employees of these organizations are often women and people of color, meaning that a disproportionate share of the burden falls on those individuals with the fewest financial resources to handle it.

Exploiting labor is not without cost to our communities. Nonprofits that are offered contracts that do not cover fair and adequate wages for its employees means that:

- The workforce is paid below market wages and, many feel compelled to work beyond the hours they are paid for given the critical needs of their clients. Ironically, this often results in workers having difficulty supporting their own basic needs.
- Turnover is abundant. The combination of low pay and oftentimes emotionally difficult work results in high burnout, particularly for the workers who serve clients most directly, the majority of whom are women and people of color. Burnt-out nonprofit employees will often look for jobs in government or in larger service providers (like health systems), because pay and benefits exceed what they can earn in the nonprofit setting.
- Staff layoffs during economic downturns creates cascading effects across the city by throwing families who lack an adequate safety net into financial turmoil.

2. Reliance on private philanthropy to cover deficits left by contracts results in financially weakened organizations and understaffed programs.



Government contracts help to create a safety net for New Yorkers by supporting services that address their basic needs. Nonprofits that deliver those services are implicitly asked to subsidize their government contracts through program fees and private fundraising because of the gap between what they are paid and what it costs to do this work. However, most nonprofits can't charge sufficient program fees to cover the costs of providing services due to the limited resources of their clients. Furthermore, private funding is insufficient to cover the full magnitude of the gap and is often unreliable as shifting philanthropic priorities result in unexpected funding shortfalls. What remains is a gap that goes unfunded, resulting in programs that are mandated by the government and that provide crucial lifelines run by overstretched staff unaided by the needed additional hires.

3. The administrative burdens of contracting results in nonprofits that can't cover their full costs of delivering critical services which in turn results in harm to NYC communities.

Running a fundraising business and complying with inflexible contracts, in addition to providing critically needed services, means that most nonprofit leaders are running an enterprise that is more complex than many for-profit models, requiring a level of management sophistication that often goes unrecognized. Diverting scarce management and staff resources to fill in the gaps created by inadequate funding, onerous and inflexible compliance requirements, and unfunded mandates means that resources that could be directed to the community are instead directed to ensuring the viability of the organization itself.

One of the most destabilizing contracting practices is around reimbursement for services rendered. Reimbursement delays wreak havoc on nonprofit budgets by forcing them to front unpaid costs and bridge payment delays. Some nonprofits resort to using lines of credit to keep the doors open because government often fails to pay contracts on time. Interest on these lines of credit is an unfunded expense the nonprofit must pay out of pocket. For instance, a 2018 SeaChange report indicated that, for the year analyzed (2017), "nonprofits receiving \$1.00 in funding under one-year city contracts registered in Fiscal 2017 needed \$0.52 in financing to bridge the gap from when they started doing the work to when the contracts were registered..."¹

¹ "New York City Contract Delays: The Facts," SeaChange Capital Partners, August 2018, <http://seachangecap.org/wp-content/uploads/2020/01/NYC-Contract-Delays-The-Facts.pdf>



In addition to the impact on the nonprofit workforce of contracting for services at rates that don't cover full costs (including the costs of compliance and unreasonable delays in payment), other impacts of this resulting financial instability include:

- Interrupted service
- Higher risk of closure
- Facilities with deferred maintenance needs, rendering them potentially unsafe and unfit for providing services and that predictably fail when most needed

Destabilizing contracting practices cause more harm than just short-term interruptions to service. Mission delivery is compromised overall through this wasted effort. Resources that could be spent on helping individuals and their communities to meet their essential needs and achieve their aspirations are diverted to addressing the gaps that harmful contracting practices create.

RECOMMENDATIONS

Nonprofits and governments are partners in addressing critical and needed services for families and individuals in New York City. However, current contracting practices are costing communities in interrupted services and in an underpaid nonprofit workforce, often women of color, many of whom head households.

Rather than relying on a handful of private donors to cover the deficit left by contracts, government needs to start paying the full cost of the services they instigate as part of its promise to the public. While an increase in overall funding can address these issue, administrative changes to government contracts are required to improve nonprofits' abilities to better serve its communities. The authors recommend two non-revenue raising changes that can improve existing contracts abilities to cover more of its full costs:

1. Make contracts more flexible and supportive of living wages by addressing the following:
 - **Mandate true cost of living rates in government contracts**, so that nonprofit employees can afford to live in the communities where they work, especially in regions that are notoriously expensive like the Bay Area, Los



Angeles, and New York.^{2 3} In addition to increasing wages, right-size programmatic expectations to reasonable work-life balance.

- **Increase indirect cost rates to at least 15%, if not 20%,** allowing a greater portion of overall contract dollars to be flexible funding to better cover the support and unfunded costs associated with contracted services; things like administrative and infrastructure support, so that nonprofits have the funds they need, and the flexibility to spend them how they're most needed. Federal negotiated indirect cost rates of 20%-25% are not uncommon, and notable private philanthropies have moved toward a standard 20% indirect rate for grants. We were glad to hear that the current NYC administration restored their pledge to pay the Indirect Cost Rate that the City had previously committed to. However, not all City contract holders have a negotiated indirect rate or have contracts that pay sufficient indirect to cover all of their unfunded mandates or costs.
- **Structure contracts to allow and encourage nonprofits to have surpluses and build reserves.** Do this by reducing or eliminating claw back provisions, which take back unspent funds, if the promised services are successfully delivered. Having a surplus is how nonprofits can create cash reserves to weather crises like COVID-19.
- **Ensure all contracts recognize and cover support costs,** which are often not allowed. This would include program staff supervision and fundraising activities needed to cover the funding gap left by contracts.
- **Reimburse for contract expenditures on time.** Or, allow interest expense for working capital loans to be included as a reimbursable expense.

2. Make the cost of contract administration cheaper — for both the city and the nonprofits — and free up administrative funding to go to providing services.

² Danielle Paquette, "The fastest-growing jobs in America pay about \$22,000 per year," The Washington Post, November 13, 2017, <https://www.washingtonpost.com/news/work/wp/2017/11/13/americas-fastest-growing-jobs-are-also-the-worst-paying/>.

³ James A. Parrott of the Fiscal Policy Institute, "Undervalued & Underpaid: How New York State Shortchanges Nonprofit Human Services Providers and their Workers," Human Services Council, March 2017, <https://humanservicescouncil.org/wp-content/uploads/Initiatives/RestoreOpportunityNow/ROnreport.pdf>.



A tremendous amount of a nonprofit's staff time and resources is consumed in meeting compliance measures and overly complex bureaucratic procedures. This depletes value from contract dollars. Streamline compliance, reporting, and invoicing to ensure greater portions of contract funding go to programs and unfunded staff salaries.

- **Allow more flexibility in how funds can be spent** (e.g., allow a homeless shelter to hire a social worker if that's what they deem most helpful, not just spend money on beds filled per night), and include provisions that allow nonprofits to align resources with new and evolving solutions for their communities — with minimal permission or administration. Enable program managers to modify the service and number served without financial penalty to fit the reality of what it takes to serve their specific community. This flexibility can ensure efforts are realistically right-sized to the contract, type of service, and specific community served.
- **Allow more flexibility in how funds are reported.** Reduce the number of bureaucratic steps and compliance documentation needed for program modifications and reimbursement payments. Staff time needed to satisfy complex reimbursement and budget modification requirements is often not sufficiently covered in contract funding. This activity also takes scarce organizational resources that could otherwise be employed toward direct services that benefit the community. Loosening reporting requirements will also reduce the need for nonprofits to maintain redundant and conflicting reporting systems that currently exist across different government agencies and platforms.
- **Ensure all contracts come with advances as standard practice** rather than an option, reducing the administrative hoops necessary to apply for advances that are now optional in contracts. Additionally, find ways to get money out the door faster so that nonprofits can provide uninterrupted services. Moreover, nonprofits that must use a line of credit from third-party lenders to bridge contract reimbursement delays should be allowed to charge interest or receive government reimbursements for the financing fees charged to them.

3. Explore Existing Contracting Models that Better Cover Full Cost



In addition to the two administrative changes recommended, we recommend New York City government explore fixed-amount contracts, which is described in the OMB guidance update noted in Section 200.45, which explicitly allows for fixed amount awards as a contracting option from federal agencies. *“Fixed amount awards mean a type of grant agreement under which the Federal awarding agency of pass-through entity provides a specific level of support without regard to actual costs incurred under the Federal award. This type of Federal award reduces some of the administrative burden and record-keeping requirements for both the non-Federal entity and Federal awarding agency of pass-through entity. Accountability is based primarily on performance and results.”*

This approach is used in Los Angeles, with the Department of Mental Health focusing on performance rather than compliance. In this structure, contracts paid a flat and fair hourly rate for services. The fixed amount meant there was no need for complicated invoicing or back-up receipts, and the funding was flexible in its use. In addition, contracts rolled over which eliminated renewal process, reducing the bureaucracy needed to manage on both the nonprofit and government side. The government agency assigned a single point of contact for each contract to navigate every aspect of the process and would work as a partner around programming and other needs.

