CAN
Alert
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California Association *of* Nonprofits

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The Price Is Right?

Nonprofits can use basic economic concepts to strengthen their finances.

By Dennis R. Young

Limited resources, but unlimited needs. It's as good of a description as any for the situation of nonprofits.

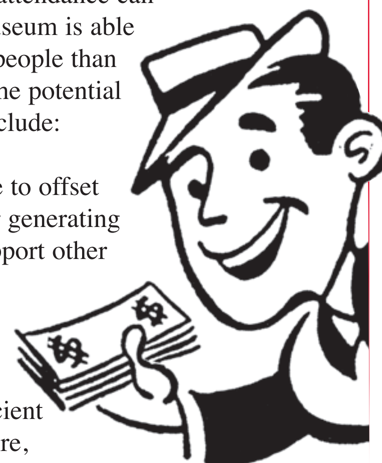
But, with the current economic downturn or recession (depending on whom you ask), needs are only expected to grow, even as resources continue to be scarce. Instead of hand-wringing, nonprofits can seize the downturn as an opportunity to use existing resources more wisely in achieving their missions.

By revisiting basic economic principles such as efficient pricing, opportunity cost and "thinking at the margin," and how those concepts can apply to their fundraising, volunteer management and social enterprise efforts, nonprofit organizations can do more in difficult times.

Approximately half of all nonprofit revenue derives from some form of earned, or fee, income. Earned income can come from charging for a variety of services such as counseling or swim lessons, selling commercial items such as educational materials, or charging admission to museums or artistic performances. *Figure 1, Aggregate Income Sources by Subsector, 2000* shows how this reliance on fees varies by field of service. That dependence is unlikely to diminish any time soon, and, with the new emphasis on social enterprise, it may even grow. But by looking at how it prices services, a nonprofit can improve its revenue base and its ability to use earned resources more efficiently.

Putting a price tag on your services

Increasing earned revenue does not necessarily mean increasing prices. In some cases, it may actually be more beneficial if prices are decreased and the organization is able to increase its audience or users. For instance, many of the museums in New York City provide free or low cost visiting days, often as part of a corporate sponsorship or partnership. On those days, attendance can skyrocket and the museum is able to reach many more people than it might otherwise. The potential benefits of pricing include:



- Producing revenue to offset costs of service or generating net revenue to support other programs,
- Ensuring a more efficient use of resources through rationing and efficient use of infrastructure,

Figure 1: Aggregate Income Sources by Subsector, 2000

	Fees	Gifts	Government Grants	Investment Income
Health	85%	4%	3%	3%
Human Services	49%	19%	23%	3%
Education	47%	17%	10%	6%
Arts	29%	41%	10%	6%
Religion	27%	57%	3%	4%
Environment	22%	51%	10%	5%
Public Benefit	21%	42%	16%	7%
International	9%	68%	17%	2%

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- Enhancing mission effectiveness by increasing consumer support and sharpening staff commitment, and
- Producing the funds needed to expand.

How do you know when it's time to change the price? When demand is "inelastic," meaning usage is unlikely to decline substantially if fees are imposed or increased, the organization probably has a strong case for a price change. Likewise, if collecting a fee is practical and can be limited so that clients who can't pay much are not excluded, or when charging for a service doesn't violate organizational norms, or when a price change can relieve congestion by spreading out services or facility usage by prompting clients to use different time slots or locations, it may be wise to revisit your pricing. Finally, if you believe that imposing or increasing fees can positively influence client or staff behavior by demonstrating that your service has value, it may be time to consider a price change.

In the for-profit world, pricing is determined by comparing the cost of providing the product or service with what people are willing to pay for it. However, in the nonprofit arena, pricing must take into account a number of other concerns, not the least of which is the expectation that nonprofits serve a greater good and have a greater purpose than earning money. Nonprofit organizations must recognize the risk that increasing their prices may reduce other sources of revenue such as donations or that a price increase may raise concerns about fairness and equity. In addition, some constituents may feel entitled to low cost or free service and imposing a higher fee can be upsetting or even incendiary.

Nonprofits can employ a variety of pricing strategies depending on their circumstance. Options include:

- Charging nothing at all,
- Charging a single (break-even or subsidized) price for maximum service,
- Charging a single price for maximum profit,
- Charging different prices to different people for the same service (price discrimination),
- Charging different prices for the same service at different times or venues (congestion or peak-load pricing), or
- Charging a single price for a package of different services (package pricing or bundling).

Smart tactics: Congestion pricing and package pricing

If you've ever booked a painfully early flight or flown on Christmas Day, you've seen congestion pricing at work. Airlines are pros at congestion pricing – limiting free flights during "black-out" days and providing greatly reduced rates for people willing and able to wake up for a 5 a.m. flight.

Congestion pricing (also known as peak-load pricing) allows an organization to reduce costs by spreading access and usage over several times or locations, without reducing demand or expanding capacity. For example, suppose The Center for Peace and Health provides yoga classes at two different locations. Both courses have a 20 person capacity and cost $10 per person. But Location A is more easily accessible to users and, as a result, has a considerable waiting list. By comparison, Location B is below capacity.

Figure 2: Uniform vs. Congestion Pricing in Yoga Classes

Price	Demand at A	Demand at B	Total Revenue	Instructor Cost	Profit	Number of Users
$10 uniform pricing	40	10	$300	$100	$200	30
$15 at A, $5 at B	20	20	$400	$100	$300	40

By increasing the price at Location A by $5 to a per-user fee of $15, the Center is able to decrease demand. At the same time, by decreasing the cost at Location B by $5, the Center is able to increase demand at the second location. See *Figure 2: Uniform vs. Congestion Pricing in Yoga Classes* to see how the Center's income and usage is affected.

By increasing the cost at Location A and decreasing the cost at Location B, the Center is not only able to reach more clients, but also increase its profit by 50 percent. In addition, the reduced cost at Location B allows the organization to provide yoga classes to people who might have been unable to afford the $10 courses.

Organizations that implement congestion pricing may experience more efficient use of existing infrastructure, such as facilities, staff and volunteers; reduce the need to expand facilities or staff and avoid capacity constraints. Congestion pricing can be used by performing arts organizations or museums (lower rates for week nights as opposed to weekends), community centers (location-dependent rates), or even educational groups (price differences at alternative campuses or with less-experienced instructors.)

Another option is to focus on package pricing or bundling. If you've ever linked your phone, Internet and cable bills together to get a bargain, you've experienced package pricing. Bundling can help clients reduce their costs and it can also help organizations to increase their income and overall usage by combining products with different demand patterns.

For an example, suppose the Y for Greater Middletown offers two kinds of recreation services to families: recreation services for youth and health club services for adults. How much families are willing to pay for these services depends in great part on their family composition and interests. Thanks to a survey of users, the Y already knows that families that are "child-focused" are willing to spend $600 a year on youth recreation, but only $300 for adult health club access. Families that are "adult-focused" are willing to pay $500 a year for adult access, but only $250 for youth services. If those services are priced separately, the Y would charge $600 for youth recreation and $300 for adult health services in order to make the most money. Then 100 families would pay for youth services only ($60,000) and 200 families would purchase adult health services ($60,000), for a total of $120,000.

Yet, by bundling adult access to the health club with youth recreation and charging $750 for the package, 200 families would buy the package, yielding $150,000. With this pricing, the Y is able to increase the overall number of users, provide more services for adult-focused families and increase revenues. See *Figure 3: Bundling Services at the Y* for a break-down of how much these different families are willing to pay for services.

Figure 3: Bundling Services at the Y

Type of family	Child Recreation Services	Adult Health Club Services	Package
Child-focused family	$600	$300	$900
Adult-focused family	$250	$500	$750

Package pricing is most appropriate where bundling can advance the organization's mission by increasing the use of beneficial or underutilized services or increase revenue over that derived from separate pricing. In addition to memberships in local Ys or JCCs, it can also be used for concert or theatre subscriptions or in prevention and treatment services (e.g. nutrition classes and medical care).

It's a matter of opportunity

Nonprofits can also think smarter economically by focusing on "opportunity cost." As you may remember from your college economics class, opportunity cost is simply the cost associated with putting resources to their next best alternative use. For instance, the opportunity cost of an orchestra conductor helping to woo a major donor might be a loss of performance quality due to reduced rehearsal time.

Here are some common examples where nonprofit professionals should carefully weigh opportunity costs:

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The Morris Stulsaft Foundation
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Union Bank of California
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Renewing Members

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Amethyst Medical Group
Assocations West Inc.
Asian Youth Center
Associated Youth Resources
Back on Track Tutoring
Bakersfield Homeless Center
Benevon
Benicia-Vallejo Humane Society
Boys and Girls Club of Moorpark

- Should we accept a large capital gift for a new building? What opportunity costs are associated with operating and maintaining the facility? How else could that money be used? Would a different kind of gift be more helpful?
- How many (of what type) of volunteers should we employ? What are the opportunity costs associated with volunteer management?
- Should the next position be filled by a volunteer or paid staff? What are the (opportunity) costs and benefits of each?
- What else would your CEO or Board president be doing if she weren't soliciting the next big gift?
- What is the opportunity cost (or benefits forgone) of underutilized facilities? How can facilities be used during off-hours (or off-season) to increase net revenues or generate mission-related benefits?

A marginal difference

Thinking at the margin means considering the value or cost associated with an additional unit of production. For instance, when you think at the margin in fundraising, you focus on the dollars that can be raised by spending one additional dollar.

Let's say printing your annual report will cost $5,000 for 500 copies or an average cost of $10. Should you print more than 500 copies? That depends on the marginal cost of additional copies, which might be only $5. If you anticipate an additional benefit of more than $5 a piece for printing, say an additional 500 copies, you should do so. Likewise, if moving your annual fundraiser to a more upscale location will cost 20 percent more, but is likely to bring in a 50 percent increase in donations, thinking at the margin should lead you to change your event location. For more on thinking at the margin, see the *Sidebar: Living on the Edge — of the Margin*.

Conclusion

By pricing their services wisely and cleverly, considering the opportunity costs of all resource-related decisions and thinking at the margin, nonprofits can ameliorate the economic downturn, use it to strengthen mission impact and improve their bottom line. Taking advantage of these strategies is simply good nonprofit management.

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Living on the Edge – of the Margin

Thinking at the margin, also called analysis at the margin, is one of the most basic tools that economists use to understand how rational decision makers can make efficient choices. The concept is deceptively simple – starting from the status quo, we ask: what if an additional unit of some resource is allocated to a certain use?

If this incremental change leads to an improvement, marginal analysis requires that the change be made, and then the question is asked again. The process continues until an incremental change no longer leads to an improvement. At that point, the resource is considered to be allocated efficiently and to have the greatest possible impact.

Traditionally, analysis at the margin was limited to for-profit business decisions focused on maximizing profits. Here's an example: Suppose a business is producing a certain quantity of a product (i.e. toothpaste) and is able to sell the product at a certain price, yielding a given level of profit. The business manager can then make two marginal calculations: What would it cost to produce another unit of the good (the marginal cost) and what would that unit sell for in the marketplace (the marginal revenue)? If marginal revenue exceeds marginal cost, then making another unit of the product is worthwhile since it will increase profits.

Businesses continue to make these marginal calculations until the marginal cost starts to exceed the marginal revenue. When this happens, we say that profit has been maximized and any additional expansion would result in losses.

Admittedly, the logic is a little more complicated on the revenue side if the product is being sold in a market where the company is a major player. In that case, the company must consider the possibility of losses due to a lower price for all of its sales in the market. Still, the basic principle remains the same – compare the marginal cost with the net marginal revenue and determine whether to take the next step.

Thinking at the margin isn't limited to retail decisions. It can also be used for thinking about other business decisions, such determining what combination of inputs (e.g, labor vs. capital equipment) to use to produce a given level of output, what activities to perform in-house versus contracting out and how to invest funds in alternative ventures. There are many different applications for nonprofit decision makers as well.

Fundraising and service pricing are two primary areas where nonprofits can think at the margin.

Fundraising

Charitable fundraising is one of the most straightforward nonprofit applications of marginal analysis. This is where maximizing profit applies directly. The object of charitable fundraising is to generate as much net revenue for the organization as possible, so that those resources can be used to underwrite the organization's social mission. As a result, fundraising should utilize the following logic: Expand the budget for fundraising as long as each additional dollar spent generates more than a dollar of contributions. Alternatively, if the budget is already too large, reduce the budget for fundraising, dollar by dollar, as long as the reduction in funds raised is less than a dollar.

Of course, there are subtleties that a nonprofit must account for in applying this rule. If funds spent in one year result in contributions in a future year, the return must be properly discounted to account for the "opportunity cost" of waiting for the funds. (See lead article: "The Price is Right?" for an explanation of opportunity cost.) In addition, if spending more on fundraising actually reduces donor propensity to give, this must be factored into the anticipated return. For example, if your materials are too glossy, people may assume you don't need any funding. Still, the basic logic of this process is unassailable.

Unfortunately, nonprofits often violate thinking at the margin in at least two ways:

First, for motivational reasons, nonprofits often set unreasonably high "stretch" goals for fundraising campaigns, without reference to the costs and revenues at the margin. Such goals are normally framed in terms of gross contributions received. But net revenues realized may not be maximized under this regime. If a goal of $10 million requires expending $9 million in resources, wouldn't it better to spend only $7 million if that yielded a

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David Zebker

return of $9 million? Trying to generate the last $1 million might actually cost $2 million and would create a net loss at the margin.

Second, nonprofits and their watchdogs are often driven by "average" thinking because averages are easier to compute and are presumed to influence donor behavior. Nonprofits that have a high average cost for fundraising are often thought of as doing something wrong. As a result, many nonprofits and fundraising federations advertise their "low fundraising costs," as computed by the ratio of gross fundraising expenditures to gross receipts, in order to look attractive and efficient to the public.

However, this can be a highly inefficient calculation if it limits the net resources that could be secured. For example, suppose in raising $1 million, a charity's average cost of fundraising is 10 percent. Further, suppose that spending an additional $20,000 would yield additional contributions of $90,000 – certainly a worthwhile investment. But this added expenditure would increase the average cost of fundraising from 10 percent to 11 percent. In this case, rigid adherence to an arbitrary average cost of fundraising (10 percent in this situation) is an inefficient practice that may limit the resources available for investing in social missions.

Pricing

Much like businesses, nonprofits charge fees for many of their services. However, the business rules for selecting prices and production levels to maximize profits do not automatically apply. Yet, you can still use analysis at the margin in your pricing.

Nonprofits produce two kinds of services: those which address the organization's social mission and those which are intended to generate net revenues to support the mission. You can analyze revenue-generating activities much like businesses do by finding the price/quantity combination that maximizes profits. When it comes to services that address the nonprofit's social mission, there are other challenges, but thinking at the margin is still useful.

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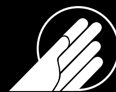

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When a business determines its profit-maximizing price and output, it balances marginal revenues with marginal costs. When a nonprofit addresses its mission, it should seek to maximize net social benefits, for example, the value the organization attaches to a certain number of clients. This means the organization will continue providing a service until the marginal social benefit it produces by serving another client is just offset by the marginal cost it incurs. Usually, this will yield a different price and output combination than would be chosen by a profit-making business.

Here's an example of what this might look like for a nonprofit:

A preventive health care nonprofit organization seeks to reduce the flu by inoculating the population of a given community. Since individuals in that community would benefit directly, most would be willing to pay some price for the flu shot. As a result, the organization could maximize its profits and produce substantial social benefits by setting the price and expanding the scale of its program until the cost of one more inoculation is just barely offset by marginal revenue. That's what a profit-maximizing business would do, but this would not maximize net social benefits, for two reasons.

First, when one person is vaccinated, this not only reduces the chance of that individual getting sick, but it also reduces the chance of contagion. Thus, the value that an individual places on his or her own inoculation underestimates its overall social value.

At the margin, therefore, some individuals (who may place a low value on their own benefit from inoculation) will choose not to be vaccinated, even though the social value of doing so exceeds the marginal cost. Economists call this an "externality," and a nonprofit will want to price its services low enough so that such externalities are properly accounted for. Indeed, if the externalities are large enough, the nonprofit may wish to produce as much output as it can (inoculate as many people as possible), within financial constraints, even though the output that it provides beyond the point of profit maximization will generate marginal revenue that is less than marginal cost.

A second reason why a nonprofit may wish to depart from the business pricing model has to do with "fairness." If some people choose not to be inoculated because they are poor and cannot afford the price, this may be seen as inequitable, and it may be part of the nonprofit's mission to address such injustice. It can choose to do so by providing free or low-cost vaccines to those who are indigent, even though such activity generates financial losses. The design of pricing schemes that help to pay for such services also requires thinking at the margin. The organization may reason that better-off citizens are willing to pay substantially more (at the margin) than they would be charged under a single price calculated to maximize social benefits. Thus, sliding scale schemes can be used to generate additional revenue at the high end in order to subsidize consumption at the low end, without losing customers or social benefits. (Note that profit-maximizing businesses also use multi-part pricing schemes to "price discriminate" when they can, but they do so for different reasons. Specifically, they try to milk more revenue from high pay customers without subsidizing anyone on the low end.)

Other Applications

Thinking at the margin has many other useful nonprofit applications. For example, consider the question of what mix of two different inputs to use in producing a service, such as, how many volunteers versus paid staff? How many staff members versus computers? How much to rely on e-mail versus snail mail? And so on. These kinds of decisions can be effectively analyzed by asking what the marginal change in output would be if there were a little more of one input (e.g. volunteers) and a little less of another (e.g. paid staff) within the context of an overall fixed budget.

Outsourcing is another important application. Here too, nonprofit managers can ask what would be the marginal impact on the organization's output if certain marginal transactions or activities (e.g. the production of a newsletter) were to be contracted out or if such a contracted activity were brought in-house. One can analyze such transactions sequentially at the margin, by beginning with core, mission-connected functions that one would be unlikely to outsource, and moving outward towards less-central activities until the margin is found where external contractors would be more productive than internal staff.

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Kitchen Food Ventures
L.A. Family Housing
Los Angeles Academy of Arts and Enterprise
Manny Mota International Foundation
Mar Vista Family Center
Meet Each Need with Dignity
Arti Mehra
Merced County Arts Council Inc
Monarch School Project
Morongo Basin Arch
Moses House Ministries
Nalley & Associates
National Children's Cancer Foundation
National Family Justice Center Alliance
Nest Feathers
No Skins No In
Nonprofit Alliance of Monterey California
Northern California Cancer Center
Optimal Literacy
Pacific Clinics
Paradise Foundation
Parents Helping Parents
Pasadena Society of Artists
Planet Aid
Project Hired
Relief International
Resounding Joy, Inc
Society for New Communications Research
Carrie Spencer
Sustainable Community Gardens
TGP, International
The Village Family Services
Time For Change Foundation
Tribal Trust Foundation
Twin Builders Foundation Corp
United Cerebral Palsy of San Joaquin, Calveras and Amador Counties
Video King
You Turn Project
YWCA of Greater Los Angeles