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Twenty years ago, it would have been shocking for the Chicago Children's Choir to run a singing telegram business and a Ben & Jerry's Scoop Shop or for Shelter, Inc., of Contra Costa County, a California organization dedicated to serving the homeless, to launch a property management firm. Today, it seems routine. Promoted in books and articles, conferences and courses, earned-income initiatives are becoming accepted—even expected—throughout the nonprofit world. In a 2003 Bridgespan Group survey of U.S. nonprofits' executives, half of the respondents said they believed earned income would play an important or extremely important role in bolstering their organizations' revenue in the future.

What's driving nonprofits to pursue profits? The phenomenon is as much social as economic. The general enthusiasm for business, which reached a fever pitch during the booming 1990s, has had a profound impact on nonprofits and the institutions that support them. Like their counterparts in the commercial world, managers of nonprofits want to be viewed as active entrepreneurs rather than as passive bureaucrats, and launching a successful commercial venture is one direct route to that goal. Board members, many of whom are accomplished business leaders, often encourage and reinforce that desire. At the same time, many philanthropic foundations and other funders have been zealously urging nonprofits to become financially self-sufficient and have aggressively promoted earned income as a means to "sustainability." As a result, nonprofits increasingly feel compelled to launch earned-income ventures, if only to appear more disciplined, innovative, and businesslike to their stakeholders. (The sidebar "The Pressure from Funders" takes a closer look at such forces.)

But while the case for earned income may seem persuasive at first glance, a closer look reveals reasons for skepticism. Despite the hype, earned income accounts for only a small share of funding in most nonprofit domains, and few of the ventures that have been launched actually make money. Moreover, when we examined how nonprofits evaluate possible ventures, we discovered a pattern of unwarranted optimism. The potential financial returns are often exaggerated, and the challenges of running a successful business are routinely discounted. Most important, commercial ventures can distract nonprofits' managers from their core social missions and, in some cases, even subvert those missions. We're not saying that earned-income ventures have no role in the nonprofit sector, but we believe that unrealistic expectations are distorting managers' decisions, ultimately wasting precious resources and leaving important social needs unmet.

Rhetoric and Reality

Earned-income ventures are nothing new in the nonprofit sector, of course. Universities, hospitals, and theater groups, for example, have long been run by charitable organizations. What is new is the breadth of interest. No longer relegated to education, health care, and the arts, revenue-generating initiatives are being launched or considered in virtually every nonprofit domain, from human services to housing to the environment. Some of the new ventures derive income from products or services within existing programs; others are completely separate from the nonprofits' core programs. But almost every venture takes the nonprofit into unfamiliar commercial waters.

Burgeoning interest in earned income has generated a flood of publications, events, and experts. How-to books with titles like *Venture Forth! The Essential Guide to Starting a Moneymaking Business in Your Nonprofit Organization* and *Selling Social Change (Without Selling Out)* have recently appeared. The Yale School of Management–The Goldman Sachs Foundation Partnership on Nonprofit Ventures sponsors a celebrated and rigorously judged business-plan competition for nonprofits; in 2004, it garnered more than 500 entries. Even organizations that promote the broader topic of social entrepreneurship, such as the Social Enterprise Alliance, are often primarily focused on earned income. At that group's 2004 National Gathering for Social Entrepreneurs, attendance "flew past 600, a 50% growth rate that dramatically illustrated surging interest in the field of social enterprise," organizers reported. And Nonprofit Business Solutions advertises that it can help "discover the earned-income opportunity you may have missed, for only $100." Indeed, the widespread enthusiasm for earned-income ventures has drowned out the handful of people, such as Greg Dees of Duke and Jed Emerson, a cofounder and former executive director of the Roberts Enterprise Development Fund, who have sounded cautionary notes.

It is clear that there has been a significant increase in the number of nonprofits considering, investing in, and launching ventures, and the press has helped create the impression that these enterprises are contributing substantial profits. In late 2001, for example, the *Chronicle of Philanthropy* ran the headline "The Business of Charity: Nonprofit Groups Reap Billions in Tax-Free Income Annually." The wide circulation of selected data reinforces the notion of a boom in earned income. From the impressive body of work published by Johns Hopkins' Lester Salamon, one statistic is mentioned with particular frequency: "Fees and charges accounted for nearly half of the growth in nonprofit revenue between 1977 and 1997—more than any other source."

But out of context, such statistics can be misleading. Fees and charges grew no faster in that 20-year period than other sources of revenue; they represented nearly half of the sector's total revenue in 1997, just as they had in 1977 (see the exhibit "No Outsized Surge in Earned Income"). And the reason the fraction is so high is that educational and health care institutions, which extensively use fee-for-service income, account for nearly 70% of total nonprofit revenue and thus dominate the data.

To more clearly document the prevalence of earned income in the nonprofit sector, Bridgespan analyzed revenue trends from 1991 to 2001. We drew our data from the IRS 990 forms that nonprofits prepare annually to report their finances. While these filings don't list "earned income" per se, they do include a category for "program service revenue," which includes government fees for service as well as private payments and fees. This is far from a perfect proxy, but it is a decent one and, in any case, it is the best available. Our analysis revealed that the relative contribution of program service revenue had actually declined by three percentage points over the ten-year period and that such revenue remains heavily concentrated in health care and education. Outside those domains,

William Foster (william.foster@bridgespangroup.org) is a manager at the Bridgespan Group, a Boston- and San Francisco–based nonprofit strategic consulting firm that is affiliated with Bain & Company and focused exclusively on the nonprofit sector. **Jeffrey Bradach** (jeff.bradach@bridgespangroup.org) is a cofounder and managing partner of the Bridgespan Group.

earned income's contribution grew substantially only among employment and community-improvement organizations. In environment and youth development, it showed a marginal gain, while in arts, education, housing, recreation, and human services, it declined slightly.

If the growth in the revenue contribution of earned-income ventures seems overstated, so does the financial success of the projects. In discussions of the topic, a handful of success stories are told again and again—cases like those of Pioneer Human Services, the Seattle-based nonprofit that offers job training and counseling to former inmates and others on the margins of society, and Juma Ventures, the Bay Area organization that gives employment opportunities to local youth. These organizations certainly deserve accolades for their income-earning endeavors, but they appear to be the exception, not the rule. At Bridgespan, we are frequently asked to assist nonprofits that have had trouble making their earned-income ventures profitable, and as part of our research we routinely hunt for similar ventures that have been profitable and might thus serve as benchmarks. We almost never find them. We have had no trouble, however, finding money-losing ventures.

Two widely circulated surveys of earned-income ventures seem to suggest that our experience is anomalous. "Enterprising Nonprofits: Revenue Generation in the Nonprofit Sector" by the Yale School of Management–The Goldman Sachs Foundation Partnership on Nonprofit Ventures and "Powering Social Change: Lessons on Community Wealth Generation for Nonprofit Sustainability" by Community Wealth Ventures (CWV) report that between half and two-thirds of the ventures these organizations examined were either profitable or breaking even. Given the challenges of accurately gauging the returns of earned-income ventures, however, we think it is important to keep in mind two caveats about these findings.

The first concerns the composition of the samples. Are they truly representative, or are they biased toward successful (and surviving) initiatives? The Yale–Goldman Sachs Foundation survey solicited research participants by highly publicizing the study through postings and advertisements. Such announcements are an efficient way to attract participants, but they amass a self-selected pool of research subjects, virtually guaranteeing a positive bias. Failing organizations are less likely to volunteer than successful ones—and ventures that have already closed their doors never do. The CWV study drew its initial sample from experts' suggestions and the researchers' personal contacts; this sample was then expanded through referrals from the initial group of nonprofits. Here again, the probability of a positive bias is high, because successful ventures tend to have a much higher public profile than unsuccessful ones.

The second caveat involves the definition of "profitable." Are the financial claims accurate? The results were self-reported, and our experience with nonprofits reveals a tendency to overlook or undercount commercial ventures' operating costs (including management time, facilities costs, and other overhead expenses). In addition, the reported "profitability" may not adequately account for hefty start-up costs. This question is difficult to assess in the Yale–Goldman Sachs Foundation study, because the calculation of financial returns is not documented in detail. There is more detail in the CWV calculations, however, and here we find that the reported financial results are probably overly optimistic.

The Pressure from Funders

To further its mission of preparing students for jobs in the culinary arts, a nonprofit job-training agency that we recently worked with raised funds to build a full-scale industrial kitchen. Hoping to earn income as well as advance the agency's social goals, managers used the kitchen to launch a café, a catering operation, and a wholesale food business. They found that by making the nonprofit seem more entrepreneurial, innovative, and disciplined, the commercial endeavors generated enthusiasm among philanthropic foundations. Funders were happy to help bankroll initiatives that seemed likely to push the agency toward sustainability.

But the results of the three enterprises were dismal. Unable to achieve high volumes, the kitchen operations lost more than $250,000 a year. Even from a mission standpoint, the ventures failed. Only ten students a year were being placed in jobs, and only a couple of them were actually going into the culinary arts. Nevertheless, the agency continued to operate the kitchen and the three businesses. Why? Because they had become an integral part of the pitch used to solicit funds. "It was," says one of the agency's leaders, "the part of our story that most excited donors about our operations."

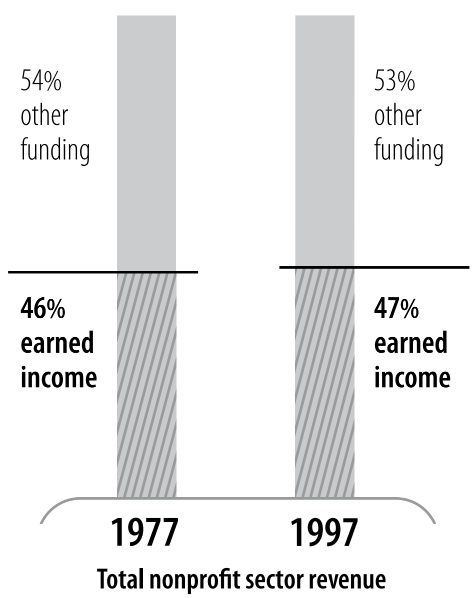
It's understandable that the nonprofit organization would be reluctant to end a program that was generating donations. At the same time, it's problematic that the part of the agency's story that funders so wanted to hear would lead a nonprofit to continue operating a money-losing program that did little to fulfill its mission.

In the CWV study's sample of 72 organizations, only four—just 5%—earned more than $50,000 in annual profit. In addition, the average time to profitability for most organizations was 2.5 years, and the average initial investment for all ventures was $200,000. Assuming a $200,000 start-up cost, two years of zero profit, and $25,000 in annual profit thereafter, a venture would take ten years to repay the initial investment, even without discounting the future profit for inflation. The venture's intangible returns may be real, but from a purely economic perspective, the same return could be generated simply by hiding $200,000 under a mattress for ten years.

To better understand the odds of success, Bridgespan selected a random sample of nonprofits that had received philanthropic funding for an earned-income venture in 2000 or 2001. (We drew the sample from a database of nonprofits maintained by the Foundation Center, a leading nonprofit research organization.) This approach limited the pool to organizations of interest to philanthropy, but it tempered the likelihood of either a positive or negative sample bias. To determine profitability, we conducted interviews with executives of 41 of these organizations—a diverse group of agencies representing the youth services, arts and culture, employment, and community improvement domains and having annual budgets ranging from $200,000 to $15 million. The ventures included both separate enterprises and core programs that had been commercialized. We excluded health and educational institutions from our sample. We also excluded basic cobranding relationships that some nonprofit organizations enter into with for-profit corporations. (The National Wildlife Federation, for instance, endorses environmentally friendly outdoor products like birdbaths sold by Home Depot and receives a percentage of the product sales.) The results were not encouraging: Seventy-one percent of the ventures reported that they were unprofitable, 24% believed that they were profitable, and 5% stated that they were breaking even. Of those that claimed they were profitable, half did not fully account for indirect costs such as allocations of general overhead or senior management time. Simply put, there is every reason to believe that the lion's share of earned-income ventures do not succeed at generating revenues beyond their costs.

No Outsized Surge in Earned Income

Revenues for the nonprofit sector have jumped from $109 billion to $632 billion in a 20-year time span. But the percentage generated by earned income (fees and charges) has stayed nearly the same.



Fees and charges include return on investments. Other funding indicates private contributions and government payments. Based on data from *The New Nonprofit Almanac and Desk Reference.*

The Disadvantages of Nonprofits

Why is there such a gap between the rhetoric and the reality of earned income in the nonprofit sector? One important factor is a lack of realism in evaluating the challenges of running a business. Launching an enterprise is difficult under the best of circumstances. According to the National Federation of Independent Business's Education Foundation, only 39% of small businesses are profitable, and half fail in the first five years. The odds are stacked even higher against nonprofits, for several reasons.

Conflicting Priorities. Unlike purely commercial enterprises, nonprofits focus on both financial and nonfinancial concerns. They may, for instance, feel obliged to pay what they consider a "living wage" or to hire employees from some disadvantaged pool of people. They may price products to be more affordable to low-income groups or offer products that are deemed "better" or "health-

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ier" than market norms. And they may reach out to customers in locations or in groups that have not had access to certain products or services.

Those are all appropriate social objectives. But they can put nonprofits at a distinct disadvantage in the intensely competitive commercial marketplace, dramatically reducing the likelihood that profitability will be achieved. Even if a nonprofit's managers and staff are as talented as its competitors', such secondary considerations can doom a venture by dampening revenues or increasing costs or both. They can also keep a nonprofit from building the kind of highly competitive, profit-focused culture that is essential to the success of many commercial enterprises.

Lack of Business Perspective. Because philanthropic contributions typically do not have significant operating costs associated with them, nonprofits can easily misjudge the actual financial contribution that a venture will deliver. In particular, they tend to overlook the distinction between revenue and profit. If a nonprofit receives an unrestricted charitable donation of $100,000, all $100,000 (except for the comparatively small fund-raising costs) can be put to work in pursuit of the organization's mission. In this case, revenue is essentially the same as profit. However, if a nonprofit generates $100,000 from a venture, such as a catering business, some of the funds must be used to cover expenses. Typically, what's left over is at best a small portion of total sales. An examination of standard for-profit business margins shows, for example, that retail eating and clothing businesses with less than $1 million in annual revenues have profit margins of just 2.5%, while the margins of similarly sized employment agencies (we cite these examples because many nonprofits operate ventures in these areas) run at only 2%. Even if we assume that the margin on a nonprofit's earned-income activity is 10%—an extremely optimistic assumption—a $100,000 business would generate only $10,000 of unrestricted funds in a year. In this regard, the widespread use of the term "earned income" to mean the revenues of nonprofit ventures has not been helpful. It has made the distinction between revenue and profit less clear.

As an example of how widely off the mark financial perspectives can be, consider the experience of a nonprofit we'll call Midwestern Youth Services, or MYS. The organization received philanthropic funding to outfit a commercial kitchen and launch a food products enterprise. It pursued the venture with gusto and hired local youths as staff. One year after its launch, the venture began selling its first product, MYS Salad Dressing, to local supermarkets. MYS prided itself on this initial success and began gearing up to increase its investment in the venture. Fueling its optimism was a sense that the business was already breaking even. The organization believed it spent $3.15 to produce a bottle of salad dressing, which it then sold for $3.50, yielding a 35-cent profit. MYS was confident that even if some costs were unaccounted for, the venture was covering its expenses and profitability was in sight.

But an analysis completed by Bridgespan revealed that the relevant expenses were far higher. MYS counted direct labor expenses as well as the cost of ingredients, but it considered only the ingredients going into the bottles and the time employees spent working on the product. In reality, the time spent preparing the dressing was a small percentage of the hours for which employees were paid. The workers' downtime was not being allocated to the product. Similarly, a significant amount of the purchased ingredients was being used for product development or was going unused. With these factors added in, the direct cost per bottle was $10.33.

Yet even that figure was an understatement. The nonprofit had also neglected to account for major indirect expenses, including the kitchen manager's salary, the facilities cost (rent for the kitchen and equipment depreciation), and the venture's share of the nonprofit's overhead (executive salaries and the like). When a modest allocation to cover these expenses was included, the cost per bottle reached a staggering $90. Far from breaking even, the venture was losing nearly $86.50 on every item it sold.

Granted, the cost per unit would shrink with increasing volume. But to break even, MYS would have to increase sales 150-fold, well beyond the kitchen's capacity. Given the philanthropic funding for the start-up costs, the absence of investors clamoring for returns, and some genuinely mission-related objectives, it is easy to see how the nonprofit ended up in this situation. But if an enterprise is designed to

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make a nonprofit more disciplined, as is often the case, or if it is intended to form the groundwork for greater financial self-sufficiency, such miscalculations can provide false comfort.

Reliance on Indirect Customers. In many earned-income ventures, the intended users can't afford the products or services. That's hardly surprising—many nonprofits work with society's most disadvantaged citizens. But it means that ventures must often rely on indirect customers for their revenues, making for complex and sometimes convoluted business models.

For example, one human services nonprofit recently developed an impressive Internet-based tool to help disadvantaged citizens search for government benefits they might be eligible for. The tool would bring these individuals a direct financial benefit, but it's unlikely they would be able to afford the necessary fees. Would corporations that also serve these people pay for the tool? It's easy to see how the nonprofit could have persuaded itself that the answer is yes—utility companies would surely rather help customers get a government credit for electricity than shut off their power. But the answer is probably no.

That's because third parties cannot calculate with any precision the financial benefit they would receive, so structuring a deal that's attractive to them would be difficult, if not impossible. The utility companies, to continue with the example, would be unable to determine how many of their customers would use the tool or receive the government benefits. And sharing customer data with third parties is never straightforward. Additionally, nonprofit organizations generally know far less about potential indirect customers than they do about their own beneficiaries, and in business, there is no substitute for a deep understanding of customer needs. In many cases, a nonprofit would be better off targeting third parties for grant requests rather than for sales pitches.

Philanthropic Capital and the Escalation of Commitment. Even when nonprofit managers realize that their ventures are facing financial problems, they rarely pull the plug. Instead, as is sometimes the case in the for-profit sector, they tend to throw good money after bad, hoping to turn the ventures around and avoid the embarrassment of failure. One nonprofit, for example, had a mission to offer teenagers a safe after-school environment with Internet access. It found a historic building with more space than the program needed. With government funds, the organization rehabilitated the building and rented out the upper floors. But the rental income didn't cover the lease and maintenance costs, so the nonprofit launched an additional earned-income activity—an after-school café selling cappuccinos and baked goods to the teenagers—to fill the gap. Unfortunately, the teenagers were not interested in, or couldn't afford, its offerings, so the café lost money too.

Rather than abandoning its money-losing ventures, the nonprofit expanded its earned-income program by extending the café's hours, broadening the menu, and opening the doors to adults. The results are not yet known, but the likelihood of success seems low. What remains is the picture of a well-intentioned nonprofit, which had simply intended to offer Internet access to teenagers, on its way to building a large, money-losing conglomerate encompassing property management and food service.

The slope for weakly performing businesses is always slippery, regardless of which sector they belong to. But the problem of commitment escalation is made even more acute when philanthropic contributions provide the funding for an earned-income venture during its first few years. Because expenses during this period are covered, the risk of losing money seems less pressing to the nonprofit. If (or, more likely, when) the philanthropic funding stops a few years later, what began as a well-funded earned-income venture may become an unfortunate legacy.

A Question of Mission

Nonprofits that take a cold look at the disadvantages of launching a commercial business will probably conclude that the odds of it generating real financial returns are extremely low. That does not mean that all potential ventures should be abandoned. Rather, it means that executives of nonprofits must ask a critical question: "Does this venture contribute to our organization's core mission?" If a venture furthers a nonprofit's mission while allowing it to recoup some portion of the costs, the venture could well be attractive even if it never breaks even.

We have found examples of earned-income ventures that do support nonprofits' missions, particularly in the area of job training. Rubicon Bakery, in Richmond, California, employs adults from a wide range of disadvantaged communities to produce premium cakes and tarts that it sells to retailers. Pedal Revolution, in San Francisco, employs homeless youths to repair and sell bicycles. These businesses operate primarily to fulfill the social goal of providing training to the poor; any money they earn in the process is a side benefit that helps them supplement their philanthropic funding.

Such success stories, however, are rare. Our research reveals that many earned-income ventures fail the mission test as well as the financial test. Our survey of nonprofits' executives asked about their motivations for starting their ventures. Thirty-two percent said they had entered into the endeavors predominantly for mission reasons, whereas 58% cited a mix of financial and mission reasons. Only 10% reported launching ventures purely for the money. But as we probed more deeply into the mission-focused ventures in this survey—and into the endeavors we encountered through our case work—we found that the meaning of "mission focused" often became blurred. In some cases, the ventures were truly central to the missions (for example, a job-training organization creating employment opportunities); others were only loosely related (a children's theater renting out costumes); for still others, there was a vague mission-related element on top of the operation (a children's choir starting an ice cream venture whose employees sing while scooping). The lure of potential "profits" not only distorts financial analysis but also thwarts an impartial evaluation of a venture's mission contribution.

Sometimes, the pursuit of profit directly conflicts with the pursuit of social good. Take the case of one environmental organization that had a unique database of statistics on important environmental issues. The broad dissemination of the information helped support the organization's causes, but the database was expensive to maintain. The organization decided, therefore, to begin charging users for access. But as soon as fees were imposed, the number of users plummeted and dissemination of the information was severely curtailed. The organization had reduced its environmental impact in its effort to generate revenue. That may be a trade-off worth making, but it highlights the complex interplay—and the managerial challenge—of balancing mission and income.

Even without such a direct conflict, an earned-income venture can impede a nonprofit's pursuit of its mission. Launching and running a venture consumes scarce management resources, diluting an organization's focus on its social programs. Consider what happened to an agency we worked with that provides training and support to the disabled. It opened a medical supplies store that proved to be chronically unprofitable—direct costs were routinely more than two times revenue. The store took up more and more of the agency's time and energy as the nonprofit's management team made "figuring out this issue" one of its highest priorities. Yet the store was doing little to fulfill the organization's mission. Only a small percentage of the agency's targeted beneficiaries shopped there. It drew only about 25 customers a week and was competing with at least ten other large stores. After ten difficult years, the agency shut down the venture.

In cases where a clear mission fit is identified, fulfilling the mission's goals through the earned-income venture may be more difficult than envisioned. One job-training organization that focused on serving the homeless wanted to expand the types of training it provided. A major soft drink company offered it the opportunity to run a distribution venture. Enthusiastic about training its beneficiaries in truck driving and enchanted by a partnership with a major corporation, the nonprofit jumped in with both feet. Unfortunately, few of its homeless clients had or could get driver's licenses. To this day, the organization has trouble hiring its target beneficiaries into the venture.

Putting Mission First

Given the low likelihood that earned-income ventures will contribute significant funds and the substantial likelihood that they will hamper the pursuit of a social mission, we urge nonprofits to ask themselves the following questions.

Rather than start with the venture's financial potential, begin with its mission contribution. Ask:

1) What set of mission-focused activities should be our highest priorities?

2) If we had additional, unrestricted philanthropic dollars, would these activities still be

our top priorities? In other words, have we made an impartial assessment of our mission priorities?

3) Do any of these activities have the potential to generate earned income? If so, which ones do and how would they do it?

4) Would generating earned income in this manner materially compromise our mission, perhaps by excluding some of our target beneficiaries from the goods or services we sell? How much management time and other resources would the venture probably consume? What's the worst-case scenario for the venture, and what would that scenario mean for our mission and finances?

If, after these questions have been answered, the opportunity still seems promising, then ask:

5) Taking into account any constraints or disadvantages we would have in running a commercial enterprise, what is a preliminary but reasonable estimate of the financial potential for each activity (for example, "The venture might be able to cover half its costs")? Have we fully accounted for all direct and indirect costs in estimating profit (management salaries, facility costs, other overhead)?

6) What additional amount of philanthropic funding would be needed to fully finance the activity?

7) Given the estimated philanthropic requirements of each activity (full cost minus realistic earned-income contribution), which activities deliver the most mission-related impact per philanthropic dollar? (A mission-promoting activity that covers half its costs through earned income could have more impact per philanthropic dollar than a less mission-focused activity that covers three-quarters of its costs.)

8) Would other new or existing activities that don't earn income bring a greater impact per philanthropic dollar contributed?

Such a mission-first approach might lead nonprofits' executives to overlook an enormously attractive business opportunity that isn't mission related. But our experience suggests that such opportunities are few and far between and that the overenthusiastic pursuit of doomed ventures is much more common. The kind of analysis we are proposing can help nonprofits avoid such missteps by imposing rigorous discipline on the evaluation of opportunities. The risk of mission drift and wasted funds will be considerably reduced.

A mission-first assessment of earned-income opportunities also returns the nonprofit sector to its fundamental principles. The reason nonprofits are nonprofits is that the marketplace does not take adequate care of the needs they address. If the most promising mission-based programs are able to generate some earned income, of course they should. For the vast majority of nonprofits, however, that is not a pathway to financial health or to mission accomplishment.

The allure of earned income is understandable, considering the way philanthropy is often practiced today. In many cases, the impulse that leads nonprofits' leaders to search for earned income is their passionate commitment to their organizations' missions; they want to help the organizations escape the challenge—and often the enormous frustration—of attracting the necessary philanthropic support. Most grants are small, short-lived, and restricted to specific uses. Earned income is precious because it comes with no strings attached. It can be used for whatever purpose the nonprofit's leaders deem most important, including operating support for programs that have proven their worth and "overhead" such as managerial talent and development that philanthropic and government funding typically do not cover.

Nevertheless, executives of nonprofit organizations should not be encouraged to search for a holy grail of earned income in the marketplace. Sending social service agencies down that path jeopardizes those who benefit from their programs—and it harms society itself, which depends for its well-being on a vibrant and mission-driven nonprofit sector.

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