Strategic Budget Cutting

By David Maddox

Budget cutting has become one of the most common and unpleasant tasks confronting nonprofit managers. While budget reductions have always been part of the normal cycles of deficit and surplus, of organizational growth and demise, "doing more with less" is now seen as a virtue worth pursuing for its own sake. However questionable that mantra may be, new waves of budget cutting are likely to hit different segments of the nonprofit sector for the foreseeable future.

Since most organizations have little in the way of unjustified spending to eliminate, there are few easy targets. Managers must approach budget cutting with care, so as not to harm the organization's capacity to achieve its purposes. The toughest question they face is how to reduce the budget without compromising the organization's mission.

Reasons for Budget Cuts

As a first step in developing a strategy for cutting budgets, the organization needs to understand the reasons driving the cuts. Some of the most common are:

- **Cutbacks by funders and governments**. Government funders will reduce funding as revenues decline or policies change. A governmental budget deficit is likely to result in reduced funding for nonprofit organizations. At times, funding cuts will be driven more by changes in policy, such as the cutbacks in appropriations to the National Endowment for the Arts that were driven by Congressional skepticism about the government's role in funding arts. Foundations and other funders may also cut back funding as a consequence of poor stock market performance or changes in their program focus.
- **Lower demand for services and the emergence of new providers**. Like any organization offering services in a market environment, a nonprofit organization may experience fluctuations or reductions in demand. Or new providers may emerge who take market share. In the education marketplace, the demand for admission to degree programs may decline as the number of high school students declines or as the economy improves. Nonprofit schools catering to adult students have

found new for-profit competitors entering the market, threatening to take students away from the traditional nonprofit provider.

- **Spending not controlled in the face of slower revenue growth**. In a period of slowing revenue, expense growth must be contained to maintain financial equilibrium. This cause for cutbacks reflects the organization's failure to respond to changes in revenue and exercise adequate financial discipline, in contrast to the external factors cited above.
- **Price competition**. A nonprofit may find that its prices for services have gotten out of line. A good example is found in health care, where some nonprofit providers have been pushed by lower-cost providers to reduce their prices, forcing them to undergo serious programs of cost reduction.
- **Unusual cost events**. In some cases, singular events may occur that drive up costs independent of the organization's ability to raise more revenue. One such watershed event was the oil crisis of the 1970s, which resulted in large increases in energy costs for institutions and arguably inflated other costs as well. Such events can force organizations to realign costs and revenues across the board.

Determining the Size of Cuts

Once an organization has concluded that cost reductions are necessary, it must determine the extent of the cuts. The size of the cuts may be mandated, in the case of government agencies, or may be determined through some sort of financial modeling. Such modeling may take a relatively informal form, such as having the organization's leaders review projections or actual programs that show a deficit and deciding what portion of the gap they will make up from revenue increases and cost reductions. In most cases, more formal financial modeling is advised to take into account timing effects and the combination effect of different factors.

For example, if positions are held vacant, the effect will build over time as the vacancies actually occur. An organization with 10 percent turnover will not experience cost savings of 10 percent in the first year of a freeze. It is more likely to see savings of around 5 percent if vacancies are evenly distributed throughout the year. In the second year of the freeze (though hiring freezes can seldom be maintained that long), the organization would have a reduction of about 15 percent in salary costs from the baseline year.

Combining a wage freeze with a hiring freeze might hobble the organization as it asks employees to do more while their wages shrink in real terms. In that case, the organization would want to give a minimal 3% raise. The net one-year savings from the hiring freeze would then be about 2.15 percent. Salary costs are just one aspect of the overall organizational financial equation that would need to be analyzed, and additional interaction and offsetting effects would be encountered.

Across-the-Board Cuts

In some ways, across-the-board cuts are the easiest to administer. The primary analytical effort rests in determining the amount to cut. For a government agency or institution, the percentage may have been legislatively mandated. In other cases, the organization needs to determine the percentage for itself. When an organization makes across-the-board cuts, the percentage is usually set and then managers are asked to develop proposals for achieving the cuts in their areas. This gives them the flexibility to make the cuts where they will do the least damage to their operations. If their budgets contain any slack, managers will identify these areas and cut them first.

The organization may decide to consider multiple levels of reduction proposals, asking for budget reduction proposals at the levels of 10 percent, 20 percent, and 30 percent. This process allows leadership to evaluate the degree of cut that can be sustained in light of the disruption to programs and services. If leaders cannot accept higher levels of cuts, they may renew their efforts to increase revenues to respond to the financial problem.

Across-the-board cuts have "surface" fairness, but they are indiscriminate. They do not account for differences in units' ability to absorb cuts, in their starting level of budget flexibility. Therefore, the organization may choose to pursue targeted cuts in which it identifies the best opportunities to reduce budgets.

Targeted Cuts

Targeted cuts can be identified and chosen by leadership itself, or through a participatory process. Leadership may make the cuts by deciding at a senior level where cuts can occur to achieve the required reduction. Each officer might offer to cut certain things in his area. A more participatory process involves more managers in identifying opportunities to reduce budgets.

Targeted cuts will start with a search for excess funding that may have been used in the past but is not entirely necessary to maintain programs and services at a minimally acceptable level. Units will also look for places in which they can hold positions vacant without undue disruption to services. Targeted cuts may extend to higher-impact decisions such as ending certain services, closing programs, or cutting back on support services. Such strong cost-cutting moves will tend to bring larger reductions in costs but will come at a higher cost in organizational morale and external relations. Therefore, it is crucial that these decisions be consistent with the organization's core strategies and with the interests of the key clients, customers, or constituencies.

A participatory approach to targeted cuts may require more cooperation and voluntary sacrifice than managers can muster. In that case, leadership may choose a select group of staff or may hire consultants to try to find these opportunities for cost reduction.

Although somewhat more extreme than most of the examples cited so far, an organization that needs to reduce costs significantly may decide that it needs to undergo a major restructuring. This would involve reevaluating the services it offers, reassessing how many departments and managers it should have, taking a fresh look at how many and what kinds of staff it has, and developing fundamentally new models for such things as the use of technology in its operations and service delivery. An organization may decide it must restructure if it determines that its financial problems are due to major changes in its service delivery arena. Perhaps the populations it serves has changed, or new options for serving those needs have emerged. Once an organization decides it needs to restructure, it has definitively moved from the realm of budgeting to that of strategic planning.

Process or Technology-Driven Cuts

One way to target cuts is to link them to process or technology changes. The organization's staff and/or consultants analyze processes to identify ways to change procedures or apply technology that will reduce the work required. Once processes are changed and technology is installed, positions and other costs can be eliminated.

This strategy usually will not produce net savings in the short run. The changes usually require time to implement — suggesting that an organization may adopt deficit budgets as it goes down this path. Also, this strategy may involve a shift from operating costs to capital as new technology is acquired. Capital costs will not immediately hit the operating statement as a drain on net income, since for accounting purposes they are treated as a transfer of assets from one asset category to another, but they may strain the organization's cash balances.

Moreover, the long-term costs of the capital investment, in terms of depreciation, replacement, and ongoing support must be evaluated against the realistic savings projected in other cost categories. Still, process or technology changes do have the potential to produce substantive changes in the way an organization does business. These can result in structural, sustainable reductions in cost. By contrast, organizations that implement across-the-board cuts often find that the costs return quickly after the sense of crisis and the period of intervention begin to lift.

It is important to remember that cutting budgets and cutting costs are not the same thing. Cutting the budget gives the organization a plan for lower spending, but achieving this plan requires discipline in specific decisions on hiring and buying made throughout the year. An organization with a strong culture of taking budgets seriously and managing to budget will find that reducing budgets results in lower spending by managers.

However, it may be necessary to adopt additional policies and procedures in order to enforce lower spending consistent with the reduced budget. These may include a freeze on filling vacancies and the establishment of a review process for exceptions. Any time managers are required to achieve budgeted cost reductions, budget performance must be incorporated in a rigorous performance evaluation system that reinforces the need to achieve specified financial goals.

Making Decisions on Budget Cutting

Organizations have several options for cutting budgets, but they still must decide how much to try to cut, over what time frame, and choose an approach. First, the organization's leaders need to have a clear understanding of the nature of their deficit.

- **Is it a cash deficit, an operating deficit, or both?** The organization's full operating statement may show a deficit, but most operating statements will include non-cash items such as depreciation. A non-cash deficit is a serious matter, because the organization is not generating the resources to replenish itself, but the negative effects may play out over a longer time frame, giving it more time to develop a response.
- **How strong are cash balances?** Deficits pose a much more immediate threat to an organization with low cash balances, leaving it with much less room for error in assessing the situation and developing the response.

Once the organization understands these basic facts about its deficit, its leaders need to consider the following factors in making the decisions about how to cut budgets and costs. First, they must consider:

- **Existing budget rules.** Certain budgeting systems include explicit or implicit rules about how to handle budget deficits. If the organization has adopted a Responsibility Center model (see Chapter 16), in most cases the managers of units which have run deficits will have the responsibility for reversing those deficits within their own unit's finances. An organization may have an understanding that once certain budget resources have been allocated to units for the year, they will not be taken back mid-year-therefore midyear adjustments must come from resources over which the central administration retains control. A deficit can get bad enough that an organization must suspend its rules due to the extreme exigency of the situation. In that case, it is critical that leadership acknowledge that it is suspending or changing the rules and be prepared to explain what about the situation is so severe as to justify this strong response.

Within the context of these budget rules (or a period of exigency that requires a suspension or change in rules), leadership needs to consider the following issues:

- **Time available for achieving a change in results.** Does the organization need to avoid a deficit in the current period, try to come up with a balanced budget for next year, or develop a multi-year recovery strategy? Financial considerations such as the size of cash balances can drive this decision, but organizational policies or politics can play an equally important role. The board may not accept deficits, or leaders may find that tolerating deficits sends the wrong message to the organization.

- **Risk tolerance.** Some strategies for cutting budgets and costs carry more risk. Investing money in technology in order to bring about major changes in the cost structure runs the risk that the cost savings returns will not equal the investment. A major organizational restructuring to reduce positions runs the risk of disrupting programs. Holding reductions to a minimum while trying to boost revenues runs the risk that the revenues will not materialize. The organization's tolerance for riskier responses is a function of the organization's culture, its resources, and the potential for positive changes in the future.
- **Dependence on and impact on external groups.** The organization also needs to assess the ways in which reductions could influence their relations with external groups, such as clients, donors or volunteers. Will cuts in certain services disadvantage the organization relative to other groups that could serve the same client base, thereby reducing its ability to win funding for its programs? Would cuts in certain services or programs inconvenience or put off significant numbers of volunteers who would then start giving their time to other organizations? Are other entities poised to pick up clients, donors or volunteers if the organization falters?
- **Quality of information**. Does the organization understand the sources of its deficits, and does it understand costs well enough to identify areas which might be better places to cut or which it can restructure through process and technology changes? The information can include how well it has articulated goals and strategies, and whether those strategies have been linked to operating activities in a way that allows the organization to make differential judgments about how activities and cost areas contribute to achieving those goals.
- **Quality of managers**. Do the managers understand their operations and costs well enough to help assess costs? Do they have the good judgment to make recommendations that have the optimal impact on costs without undercutting the organization or its programs? Do they have the skill to implement major changes?

If leaders do not trust their managers, or do not trust them consistently, it will be hard to adopt a program that pushes much of the decision-making about budget cuts back onto the managers. Some recovery strategies, such as implementing major process change in a way that reduces staff levels, require significant management skill to pull off.

• **Trust levels within the organization.** Are the members of the organization well-aligned around a common vision of the organization and its situation? Do they work well together and support each other? Has leadership succeeded in establishing communications within the organization? Trust may need to extend to board members, donors and volunteers as well.

The trust levels in the organization may determine its ability to accept differential cuts, or for some units to sacrifice resources on behalf of the whole. Establishing trust is a matter of behavior as well as communications-leaders need to behave in ways that inspire trust. For example, if leaders ask for some units to bear the brunt of budget cuts, they must make sure they chose those cuts based on legitimate operating considerations, and did not inflict cuts on managers or units which had fallen out of favor for one reason or the other.

• **Political clout of leadership within the organization.** Does leadership have the ability to align people behind a course of action and to convince them to accept some moves which may be unpopular or distasteful? When an organization needs to cut budgets, it often does not have the time to wait for consensus to develop behind a response. The organization's leaders may need to use political influence within the organization to get people to go along with something.

If leaders do not have the political skills or weight, they may need to avoid strategies which require higher levels of participation and collaboration from people throughout the organization.

Based on their answers to these questions, leadership should develop its approach to cutting budgets. In an organization with low trust levels and relatively poor information, the best approach may be across-the-board cuts. Although it has the potential for more sustained impact, relying on process or technology changes is somewhat riskier, so it may be a better choice for an organization which has a longer timeline for its recovery, resources for investment, and management talent for implementation.

Communicating Budget Cuts

In addition to deciding how much to cut and what approach to take, the organization's leaders need to determine how to communicate their actions to the rest of the organization. Once people start to hear about budget cuts, they start to worry about their own jobs, programs and clients and about their friends in the organization. Morale may decrease and distractions increase.

For these reasons leadership may want to keep its budget-cutting activity quiet. This may be a good idea, especially if their actions can be discrete and have minimal impact on members of the organization, such as negotiating better rates when contracts come up for renewal or changing expenditure patterns out of central funds.

In most cases, however, leadership cannot insulate members of the organization from budget and cost cutting. Therefore, they must say something about the reasons for taking action and about what will happen. Each organization will need to make its own judgment about the amount of information shared and the tone of it. It may not be appropriate or useful for leadership to share everything it knows about its cost trends, although some information about its specific expectations can be useful.

The organization also needs to decide whether to describe its situation in terms of a crisis, or to soft-peddle it. Some writers on organizational change have argued that an organization will change only if the people in it share a sense of crisis and can mobilize themselves to respond to it, as a nation does in time of war. However, in some situations the sense of crisis can get exaggerated beyond the true scope of the situation, and distract people unduly from the organization's normal business.

One way of looking at the decision about tone of the communications is to ask whether this a situation in which the organization needs everyone to drop what they are doing, roll up their shirt sleeves, and help dig out of this mess, or is this a case in which people should know that the organization is facing some difficulties, but leadership is working on it and is confident that they can respond with minimal disruption, so people should just keep doing what they are doing and be prepared to help out when they are asked.

In communicating about budget cuts, leadership needs to keep in mind a few points:

- **Assume that everyone is looking for the answer to one question—will I lose my job?** This means that everything said by or on behalf of the organization and leadership will be scrutinized very closely, hunting for implicit clues that suggest the extent of layoffs or that jobs will be guaranteed or protected. This means that if a dollar savings target is announced, some people will divide that by what they believe is the average salary to come up with the number of positions they think will be eliminated, even if there is no intention to cut positions. On the other hand, an announcement that the organization expects to achieve cost reductions through attrition may be interpreted as a guarantee of no layoffs.

- **Keep the messages clear**. People can exercise selective hearing during this process. If leadership tries to make an overly nuanced pronouncement on the budget cutting process, the nuance may be missed and people may hear a more discouraging or encouraging message than was intended. If leadership has decided to try to place everyone who wants one in a new job, but wants to retain the right to offer a lower salary for the new position, they need to be careful not to say something that is interpreted as a guarantee that no one will lose their job and everything that goes with it-responsibilities, pay, etc. On the other hand, in this case one would want to be careful not to suggest that the organization is going to cut pay rates if that is not the case.
- **Be careful what you promise**. People will remember the statements leaders make. The organization should be sure it won't have to lay off people before anyone makes a statement that rules out layoffs or some other painful move. Once the statement has been made, it either limits the actions the organization can take or forces leaders to forget about the earlier statement (usually people in the organization don't allow these statements to be forgotten) or to recant it, exacerbating the negative effects on morale and trust.
- **Don't expect to make everyone happy**. You cannot control everyone's interpretation of events. Periods of budget cutting are difficult times, and after making a good effort to communicate effectively, management has to accept that some people in the organization will be angry and will not accept the organization's "party line." Leaders will move forward in spite of these sorts of difficulties, although they will do what they can to reduce them. Communicating during a period of organizational stress is not easy.

Many organizations find it useful to adopt a formal communications plan early on in such a painful process. This plan would specify the audiences for communications, the information they should receive, and the timing and vehicles for communicating to them. Certain messages need to come directly from the organization's leader, others can come from more immediate supervisors. Often an organization needs both face-to-face communication of information and formal documents that record and disseminate key elements of the analysis, process and response.

The organization should also assess the need for messages to outside groups, including in some cases the local media. An organization which has a significant profile within its community may find that the media start to pick up news of its internal actions, and may need to take action to educate the media about what it is doing.

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