Hawai`i State Policy & the Nonprofit Sector

optimizing the relationship between nonprofits and government

Submitted by:

The Hawai`i Community Services Council &
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Submitted to:

Office of Planning
Dept. of Business, Economic Development & Tourism

Date:

December 2002

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Executive Summary

Through expanded contracting activity, new forms of regulation and oversight, and innovative forms of public support, the role of state government in the nonprofit sector has grown significantly over the past 15 years. Yet, the relationship between government and the nonprofits has remained largely unexamined. In August of 2002, the Department of Business, Economic Development & Tourism contracted the Hawai`i Community Services Council (HCSC), in collaboration with the Hawai`i Institute for Public Affairs ("HIPA"), to assess the impact of the State's regulations, public policies and procedures upon the nonprofit sector. This report documents the findings and recommendations from the study.

Hawai`i's Nonprofit Sector

- Hawai`i's nonprofit sector is larger than most other states' and is growing at a faster rate than the rest of nation. We have more nonprofits per capita than the national average and the number of nonprofits here grew by roughly 50 percent between 1992 and 1999.
- The nonprofit sector is an important contributor to Hawai`i's economy, with employment, revenues, and growth that have outperformed other industries during the past decade. The sector represents more than 9% of total employment and 10% percent of total payroll for Hawai`i. It is the fourth largest employer behind Government, Services, and Retail Trade.

The Government – Nonprofit Relationship

- The nonprofit sector has unique advantages that allow it to complement, but not substitute for, State government. These include special *community networks and knowledge*, and the ability to *innovate*, *leverage* private resources, and *weather electoral cycles*.
- State government has four primary points of contact with the nonprofit sector: it is a *coordinator and planner* of public services, *customer* of nonprofit services, provider of *business and industry supports* to nonprofits, and controls *regulation and taxation* which impact the sector.
- Given the strengths of nonprofits, the State should focus on utilizing them when one or more of the following applies: (1) rapidly changing community conditions require flexibility or innovation; (2) the State lacks specialized local knowledge and relationships to promote program objectives; (3) a long-term approach beyond electoral cycles is required; (4) private funding or volunteer labor can cut costs.

The State as Planner & Coordinator

- Currently, planning and coordination between State agencies and between the State and the nonprofit sector is limited. Some of the mechanisms that exist for statewide planning like the State Plan and Functional Plans are not being utilized. Planning with these mechanisms could help nonprofits set priorities and reduce duplication of service.
- Some of the tools that exist to promote involvement of the nonprofit sector in planning like the Functional Plan Advisory Committees are underutilized. Increased

involvement of nonprofits in planning through such mechanisms could enhance program outcomes.

► Recommendations

(1) Reintroduce regular updates of the State Plan and Functional Plans. The Plans should be used to direct program design and procurement and should be widely shared with the nonprofit sector.
(2) State and nonprofit leaders work to increase involvement of nonprofits in State planning through existing mechanisms like the Interagency Committee on Purchase of Health and Human Services, and the Community Council.

The State as Customer

- The impact of State contracting and payment practices was a central area of concern for study participants.
- Unit cost and fee-for-service contracts do not cover many start-up costs and fixed expenses borne by nonprofit providers. Such contracts also make it difficult for nonprofits to maintain capacity when client levels fluctuate.
- Most State contract payment schedules do not cover the cost of initial operating expenses. Furthermore, delays in payment threaten nonprofit operations, particularly for smaller, community-based organizations.
- Lack of standard contracting procedures and reporting requirements places serious burdens on nonprofit providers and prevents some smaller, community-based organizations from participating in State programs.
- The State has begun to shift toward outcomes-based contracting. While the model carries many benefits, new standards must mitigate the risks of creaming the crop, sacrificing quality for quantity, and narrowing nonprofit missions.

► Recommendations

(1) Provide an initial payment at contract signing to cover initial operating expenses.
(2) Guarantee a minimum payment level adequate to maintain a minimum level of capacity even through temporary fluctuations in the number of clients.
(3) Structure payments to provide profit adequate to support capacity building or provide specific grant funding for this purpose.
(4) Explore contract set-asides and modified payment schedules to allow smaller, community-based nonprofits to participate in State contracting.
(5) Coordinate reporting requirements between State agencies, creating standard forms and schedules to the maximum extent feasible.
(6) Structure performance-based contract payments to mitigate the risks inherent in such contracting (e.g., combat creaming by paying more for hard-to-serve clients).

The State as Business Support Provider

- Despite its important contributions to the economy, business supports for the nonprofit sector are lacking. Although the sector is larger than Agriculture, Manufacturing, and High Technology, the State has invested in business supports for these industries, while no such supports exist for the nonprofit sector.

- Nonprofits lack access to many existing business assistance programs like small business technical assistance programs, loan guarantees, worker training, and tax incentives.
- Few sources of funding exist to support building nonprofit business capacity. Lack of funding for capacity building hampers nonprofits' ability to increase efficiency and improve quality of services.
- In the absence of State business and industry supports for the nonprofit sector, private foundations and the nonprofit sector itself have begun to develop some assistance programs. These programs could benefit from State support.

► Recommendations

(1) Existing, State-supported business and industry assistance programs should be made available to the nonprofit sector. Alternatively or additionally, the State should explore ways to work with emerging providers of business assistance to the nonprofit sector.
(2) The State should make an investment in business supports for the nonprofit sector commensurate with the sector's importance to the local economy. It should investigate the costs and benefits of creating industry-specific support programs.

State Regulation & Taxation

- The new Nonprofit Corporations Act is the central legal instrument governing nonprofit organizations in Hawai`i. The law affects many aspects of nonprofit operation.
- The new Act imposes some new requirements upon nonprofits, but has been generally well received by those familiar with it. However, it is still not well known or understood by many in the nonprofit sector.
- Nonprofits are affected by the same laws and regulations that affect all Hawai`i businesses. These laws can have a disparate impact on nonprofits, whose operations differ from that of for-profit entities. For example, tort liability laws can seriously affect volunteer-dependent nonprofit organizations.
- Changes in the sector are making it increasingly difficult for State government to make effective tax policy with respect to nonprofits. Hawai`i's has just begun to grapple with many of these complexities. In some cases, initiatives to increase nonprofit understanding of tax or regulatory requirements is needed. In others, relief from regulatory or tax burdens may be appropriate.

► Recommendations

1) Consider providing relief from some of the general business laws and regulations that have a disparate affect on nonprofits, e.g., providing insurance coverage for use of automobiles by volunteers.
2) Consider providing the same regulatory relief to nonprofits that are provided to all small businesses, such as expansion of access to affordable General Liability and Property insurance from the Hawai`i Employers' Mutual Insurance Company.
3) Provide State-sponsored workshops or other information on the new Nonprofit Corporations Act to Hawai`i nonprofits.

4) Consider exempting all nonprofit income from the State General Excise Tax, provided such income is to be used for furtherance of the charitable purpose for which the nonprofit was established. Evaluate the cost to the State in foregone taxes and regulation that would be required.

Conclusion

Given changes in the nonprofit sector and the complex relationship between government and nonprofits, creating State policy with respect to the sector is an increasingly challenging task. We hope this report provides some guidance to the State and to nonprofit leaders, and that it helps shape policies which work to the benefit of government, the nonprofit sector, and Hawai`i's communities.

Background

Over the past fifteen years, state governments across the country have increased their involvement in the nonprofit sector. Through expanded contracting activity, new forms of regulation and oversight, and innovative forms of public support, the role of state government in the nonprofit sector has grown significantly. Hawai`i is no exception to this national trend. The state's nonprofit organizations are increasingly affected by the complexities of State procurement, regulation, and aid. Yet, as the Aspen Institute noted in a recent study, "despite its importance, the relationship between government and the nonprofit sector has grown without a great deal of attention or focus."[1]

Study Objectives

In August of 2002, the Department of Business, Economic Development & Tourism contracted the Hawai`i Community Services Council (HCSC), in collaboration with the Hawai`i Institute for Public Affairs ("HIPA"), to conduct a study of State government and the nonprofit sector in Hawai`i. The study was to assess the impact of the State of Hawai`i's regulations, public policies and procedures upon the nonprofit sector.

Methods

A multi-disciplinary Advisory Group representing government and the nonprofit sector was convened to oversee work on the project and provide guidance to the research team. A list of Advisory Group members is provided as Appendix B. In their initial meeting, the Advisory Group defined key research questions for the study. The questions ranged from broad (e.g., 'what is the public sector seeking to accomplish by supporting nonprofit organizations?') to highly specific (e.g., 'how can the State improve the timing and structure of contract payments?').

The research team categorized questions of the Advisory Group into five areas:

(1) general questions seeking to *clarify the role of the State* in the nonprofit sector;
(2) questions related to the State's role as *planner and coordinator* of public services;
(3) questions related to the State's role as a *customer* of nonprofit services;
(4) questions related to the State's role as a *supporter* of the nonprofit industry's development; and,
(5) questions related to the State's role in shaping *regulation and taxation* affecting nonprofits.

Subsequent research focused on developing findings and recommendations in these five areas. The study employed several methods of research including a review of the literature on issues and trends affecting Hawai`i nonprofits, a review of quantitative data on Hawai`i's nonprofit sector, and interviews with key local and national informants. The study also

[1] Aspen Institute, Nonprofit Sector Strategy Group. The Nonprofit Sector and Government: Clarifying the Relationship (Colorado: Aspen Institute, 2000), p. 4.

draws from and builds upon past work including the work of the Hawai`i Together Payment & Contract Sub-Committee and Hawai`i Community Foundation studies of the nonprofit sector and its role in the Hawai`i economy.

As used in this report, the term "nonprofit" generally refers to organizations that are registered as Hawai`i nonprofit corporations and are tax exempt under Section 501(c)(3) of the Internal Revenue Code. Such organizations are provided tax-exempt status by the federal government and can receive tax-deductible donations because they are organized and operated for charitable, educational, or religious purposes. The term does not necessarily exclude other types of tax-exempt organizations (e.g., Civic Leagues under Section 501(c)(4); Labor or Agricultural Organizations under Section 501(c)(5); Trade Associations under Section 501(c)(6), etc.), but the findings and recommendations in this report are most relevant to 501(c)(3) entities.

Report Overview

The remainder of this report documents the findings and recommendations from the study. It is divided into seven sections. Section I profiles features of Hawai`i's nonprofit sector that are relevant for purposes of this study; Section II attempts to clarify the relationship between nonprofits and State government; Sections III though VI explore the four major ways that State government impacts nonprofits in Hawai`i: as a *coordinator* of public services, as *customer* of nonprofit services, as *supporter* of nonprofit business development; and as maker of *regulatory and tax* policies affecting nonprofit activity. The final section provides concluding remarks.

Section I: Hawai`i's Nonprofit Sector

Hawai`i's nonprofit sector is larger than most other states' and is growing at a faster rate than the rest of nation. It is comprised largely of well-established entities and a mix of organization types similar to the national nonprofit population.

The nonprofit sector plays a critical role in the lives of Hawai`i's citizens. Its roughly 6,000[2] organizations work to address an extraordinary range of issues, from enhancing the health of Hawai`i's people, to providing social services, to fighting illiteracy, to promoting the arts. The types of services provided and the scope of these services varies widely between nonprofits. One-quarter of Hawai`i nonprofit organizations serve a target geographic community (i.e., are neighborhood- or community-based), while 33 percent serve one or more counties and 44 percent serve the entire state.[3]

Hawai`i's nonprofit sector is large relative to that of other states. Our state has more nonprofit organizations per capita and a greater share of total employment in the nonprofit sector than the rest of the country. Interviewees perceived a proliferation of nonprofits in Hawai`i over the past decade, a perception that is confirmed by the available data: the National Center for Charitable Statistics reported that the number of nonprofits in Hawai`i grew by roughly 50 percent between 1992 and 1999, outpacing growth of the sector nationally.[4]

Contrary to the common view of nonprofits as unstable entities living from grant to grant, nonprofits in Hawai`i are generally well established. A study by the Hawai`i Community Foundation in 2001 found that over three-quarters of the state's nonprofits have existed for more than 10 years and half have been around for 20 years or more.[5]

The composition of the nonprofit sector in Hawai`i by type of nonprofit is comparable to that of the nation as a whole (see Figure I-1). Like the rest of the U.S., the largest segments of Hawai`i's nonprofit population are in Human Services (23 percent), Education (15 percent), and Health (13 percent). Compared to the rest of the nation, Hawai`i has a slightly smaller proportion of its total nonprofit population in Health, Human Services, and Community Development and a slightly larger share in Culture and Arts and Education.

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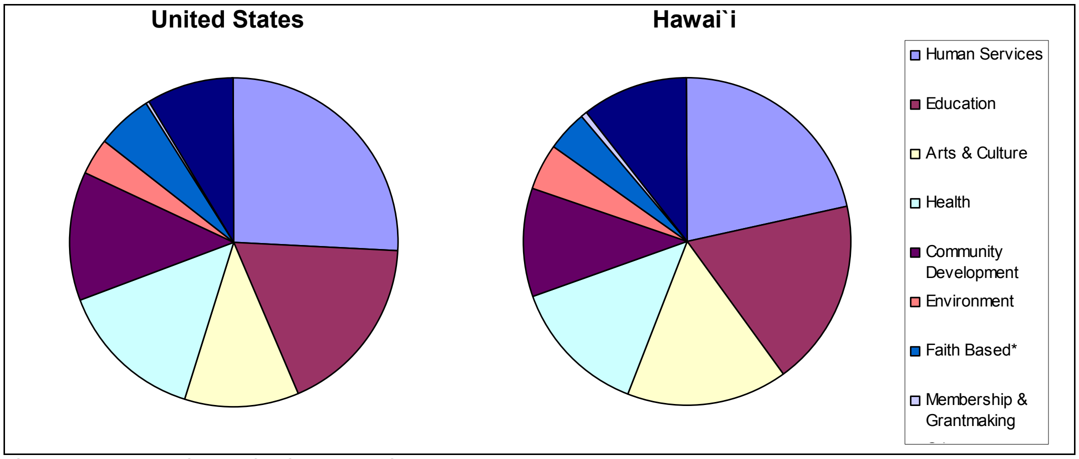
[2] This count includes all nonprofits, operating and grant making of all income and asset sizes.
[3] Hawai`i Community Foundation, Hawai`i's Nonprofits 2002: a Study of the State's Silent Economic Partner, (Honolulu: 2002), p. 3.
[4] National Center for Charitable Statistics, "Reporting Public Charities in the United States by Type, 1999" and "Reporting Public Charities by State by Type, 1999" June, 2001; "Reporting Public Charities in the United States by Type, 1992" and "Reporting Public Charities by State by Type, 1992", June, 1994.
[5] Hawai`i Community Foundation, Hawai`i's Nonprofits 2002: a Study of the State's Silent Economic Partner, (Honolulu: 2002), p. 2.

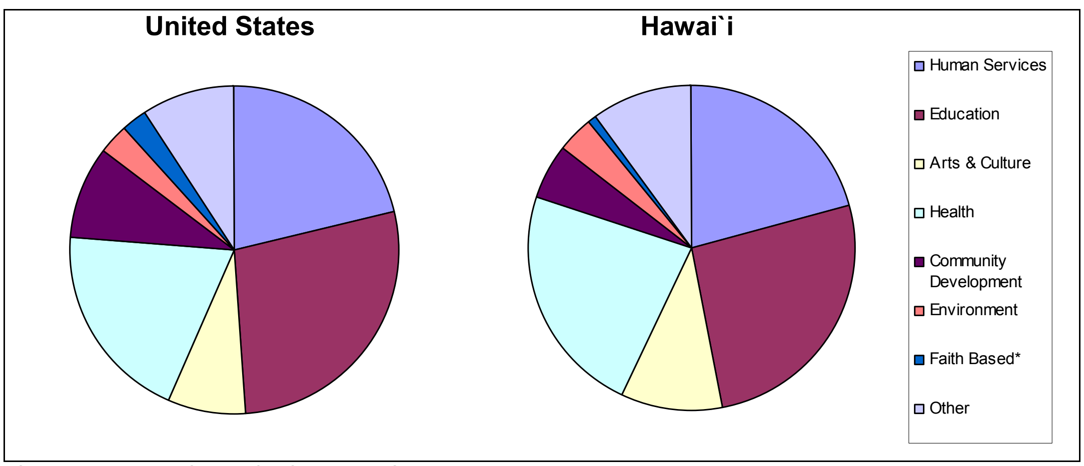
Figure I-1: Nonprofit Organizations by Type



Source: National Center for Charitable Statistics, 2001.

Hawai`i's pattern of public support[6] for nonprofits also varies only slightly from the national picture (see Figure I-2). Hawai`i directs a greater proportion of its public support to Arts & Culture and Health organizations and a smaller proportion to Community Development agencies than the rest of the country.

Figure I-2: Public Support by Nonprofit Type



Source: National Center for Charitable Statistics, 2001.

The nonprofit sector is an important contributor to Hawai`i's economy, with employment, revenues, and growth that have outperformed other industries during the past decade.

In addition to having a large presence in terms of sheer numbers of organizations, the nonprofit sector is also a large and growing economic force in Hawai`i. The sector

[6] "Public Support" includes gifts, grants and contributions from government and private sources. Data from reports prepared by the National Center for Charitable Statistics, "Reporting Public Charities in the United States by Type, 1999" and "Reporting Public Charities by State by Type, 1999" June, 2001.

represents more than 9 percent of total employment and roughly 10 percent of total non-agricultural payroll for Hawai`i. Indeed, it is the fourth largest employer behind Government, Services, and Retail Trade, and supports more jobs than the Construction and Manufacturing sectors combined.

Along with being a large employer and revenue generator, the nonprofit sector contributes to the Hawai`i economy in other ways. It has exhibited steady growth for the past decade, in contrast to most other industries and sectors. While the state experienced a severe economic slump from 1992 to 1997, the nonprofit sector saw a 36 percent increase in gross revenues (the largest of any industry or sector) and outperformed the rest of the economy in employment and payroll growth as well.[7] Yet, few recognize the important role that the sector plays, helping to diversify the state's economy and counter cyclical economic downturns tied to tourism.

Local and national forces are confronting Hawai`i nonprofits with greater service demands, fewer resources, and changes in industry practices. Nonprofit mergers and hybrid nonprofit/for-profit ventures are the result.

Local and national forces are challenging Hawai`i's nonprofits. Among the most prominent forces at work are:

- **Devolution and a contracting welfare state.** Devolution of government functions has shifted the social service burden from federal to state and local agencies. With increasing frequency and scale, State and Local governments are contracting with nonprofit organizations to provide services to the public (this issue is discussed in greater detail in the next section). At the same time, the conservative shift in Federal budget priorities has left fewer resources to support domestic social programs.

- **Dwindling private funding.** Due to a slumping local economy during the 1990s, and capital market shocks following September 11th, charitable giving by individuals and businesses has been low in Hawai`i for several years. In 2000, Hawai`i ranked 48th among the states in terms of the average size of gifts to tax-exempt organizations and increases in giving from 1996 to 2000 did not keep pace with the rest of the nation. Due to volatility in the capital markets, foundation giving has also been curtailed. As an example, the Aloha United Way reports that its allocations are down 15% from 2001.[8]

- **Changing technology.** Like all sectors of the economy, nonprofit organizations have struggled to keep pace with technological change. Acquiring new technology places new fundraising and operational burdens on nonprofit organizations. It has

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[7] Data on tax exempt service organizations from the U.S. Census Bureau, Economic Census, 1992 and 1997.

[8] Data on giving from the National Center for Charitable Statistics, 2000 Giving Patterns Across the States. AUW allocation data from the Hawai`i Together Payment & Contract Sub-Committee, Report to the State of Hawai`i, October, 2002.

also dramatically changed the way many nonprofits do their work, demanding a reorganization of positions, responsibilities, and functions including accounting, reporting, client monitoring, and technology support.[9]

- **New emphasis on outcomes.** Since the 1990s, public and private funders have encouraged the use of outcome measures to gauge nonprofit performance. The shift in emphasis has meant that nonprofits have had to retool many of their systems of gathering client information and accounting for their activities. This focus has also challenged nonprofits to avoid narrowing their missions, and resist 'creaming the crop' of clients in order to reach outcome targets.

- **Challenging local social and economic conditions.** Changing conditions in Hawai`i's communities have also served to increase the scale and variety of needs that nonprofits must address. An influx of new immigrant populations – notably Pacific Islanders and Southeast Asians – has created new challenges for agencies seeking to train, educate, and employ those in need. Dramatic swings in unemployment created by external shocks like the Gulf War and the September 11th terrorist attacks also continue to strain the capacity of nonprofit organizations.

The net effect of these converging forces has been an increase in demand for services, fewer financial and human resources to respond with, and shifts in nonprofit industry practice (new technology, State contracts, outcomes standards, etc.) that have stretched many nonprofits to the limits of their capacity. In an effort to deal with these conditions, many nonprofits have adopted a range of coping strategies.

Among the emerging strategies is *hybridization* – efforts by nonprofits to develop revenue-generating lines of business to support their work.[10] In many cases, nonprofits create profit-making programs or subsidiaries that are consistent with their social mission but which also produce profits which can then be used to support the nonprofit's subsidized programs. For example, Alu Like, Inc. recently spun off a for-profit subsidiary that will manufacture and commercialize equipment for Lawrence Livermore Laboratories. The venture is consistent with Alu Like's social mission: it will hire and train Native Hawaiians from the economically distressed Hilo area and all profits will be used to support Alu Like's nonprofit programs. Another example of blending for-profit and non-profit tactics is Mala `Ai Opio (MA`O) – a nonprofit "youth organic farm" in Waianae, O`ahu. MA`O that grows and sells fresh produce to the community while also offering at-risk youth paid employment and an opportunity to learn about agricultural science, entrepreneurship, and leadership. Other nonprofit organizations – particularly those working on issues of employment and economic development – are pursuing similar hybridization strategies.

Another coping strategy beginning to appear in Hawai`i is mergers and partnerships between nonprofit organizations. In an effort to cope with limited resources and reduce duplication of services, several Hawai`i nonprofits have created close alliances with similar organizations,

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[9] Saidel & Cour, Information Technology and the Voluntary Sector Workplace, Independent Sector Research Forum, (Washington D.C.: 2001); Osten, Marc, "Who Ya Gonna Call? (When Your Computer is Possessed)", Nonprofit Quarterly, Summer 2002, p. 53.

[10] Aspen Institute, Nonprofits and the Market: Challenges & Opportunities, (Colorado: 2001).

or, in the most extreme cases, merged with these organizations completely. A merger between the Maui Chamber Music Festival and the Maui Symphony Orchestra in 1999 was the first of its kind in Hawai`i. The merger had mixed financial results, but did succeed in mobilizing new stakeholders and the community to support the merged organization. Other mergers have since followed, with final results as yet unclear.[11]

[11] Conger, Jean, "Mergers, Consolidations and Partnerships: A Look at Strategic Restructuring of the Nonprofit Sector in Hawai`i." A Report for the Hawai`i Community Foundation, (Honolulu: 2002).

Section II: Clarifying the Relationship

One set of questions raised by Advisory Group members revolved around the general issue of clarifying the State's relationship with the nonprofit sector. Among the questions raised were, "What is the public sector seeking to accomplish by supporting nonprofit organizations?" "What should the role of government be in the areas of service provision, planning and partnering with nonprofits?" and, "How can this project bring greater clarity to how the system should work?" Answering these questions required examination of the inherent advantages of the nonprofit sector and the various 'points of contact' between government and nonprofits.

The nonprofit sector has unique advantages that allow it to complement, but not substitute for, State government. These advantages include specialized community relationships and knowledge, and the ability to innovate, leverage private resources, and weather electoral cycles.

Although they are a critical force in addressing matters of public concern, nonprofit organizations are not a substitute for government. The public and nonprofit sectors bring different strengths to their common pursuit of the public good. The strength of government lies in its ability to muster vast resources through taxation, to address widely shared needs that are identified through the democratic process, and to coordinate priorities and activities across sectors. Democratic and bureaucratic constraints mean government programs sometimes have difficulty addressing the specialized needs of specific communities or populations. These constraints also limit government's ability to innovate or alter programs to meet rapidly changing needs.

The strengths of the nonprofit sector complement those of government and compensate for some of its weaknesses. Four strengths, in particular, define the unique advantages of the nonprofit sector in creating public value.

- **Flexibility and an ability to innovate.** Nonprofits can adapt to changing conditions and needs without the constraints of politics or bureaucracy. The sector can pursue unique causes and can tackle emerging issues that have not yet received broad political endorsement. It can also innovate and experiment without fear of voter retribution.

- **Specialized knowledge and relationships.** Many nonprofit organizations maintain specialized, local knowledge and relationships with community groups, other nonprofits, or neighborhood leaders that allow them to be particularly effective in serving target communities and populations. In many cases, government lacks such specialized networks and information.

- **Ability to take a long term approach.** With diverse sources of public and private support, nonprofit organizations can weather political cycles – working to address issues over a longer time horizon than government or the private sector.

- **Ability to leverage resources and control costs.** Nonprofit organizations can leverage funding from private foundations and individuals decreasing the public cost of providing services. They can also control expenses by utilizing volunteers and are not subject to civil service hiring requirements that increase labor costs for government.

In general government-nonprofit relationships that play to the strengths of each party promise the greatest public benefit.

State government has four primary points of contact with the nonprofit sector: it is a *coordinator and planner* of public services, *customer* of nonprofit services, provider of *business and industry supports* to nonprofits, and controls *regulation and taxation* which impact the sector.

State government interacts with the nonprofit organization in a variety of ways. The most obvious of these is the contractual purchase of services, but the extent of the relationship between government and nonprofits is far more varied and complex than these transactions. A wide array of State policies impacts the nonprofit sector: State tax policy affects charitable giving; liability law affects volunteerism; corporate law affects nonprofit start-up requirements and governance; business regulation affects reporting and the cost of operations; the list goes on. Clarifying the relationship between government and the nonprofit sector requires some classification and simplification of this complex array of relationships. We found that government plays four central roles in the nonprofit sector:

- **Planner and Coordinator.** State government is in the best position to identify priority social issues, define an agenda for public action, and coordinate efforts across geographic and sectoral boundaries. By setting clear statewide goals and priorities and making these known to the public and other stakeholder institutions, government can help public and private agencies reduce duplication of service, and coordinate strategic efforts that are consistent with State priorities.

- **Customer.** Government is a customer – the leading customer – of the nonprofit sector's products and services. In areas ranging from policy research to training to direct provision of human services, government is a large and increasingly important purchaser of services from the nonprofit industry.

- **Provider of Business Supports.** In its role as a steward of the state's economy, State government creates programs designed to encourage business and industry development. For example, the State funds programs that provide small businesses with technical assistance, creates tax incentives designed to promote the growth of certain sectors, and creates special credit and marketing programs to support target industries. Many of these business and industry supports affect nonprofit organizations.

- **Regulation and Taxation.** "Regulation" is used here in the broadest sense and includes those laws, administrative rules, and monitoring actions designed to control organizational behavior in ways that protect the public. Government is a regulator of the nonprofit sector on many levels. Some forms of regulation – like financial reporting requirements for charitable organizations – are specific to nonprofit organizations. Others – like requirements that employers provide health insurance – affect all firms and industries. We also considered government tax policy as a form of regulation that affects nonprofits.

Achieving a clearer understanding of the ways that government interacts with nonprofits, the affect of these interactions, and the unique advantages of the nonprofit sector helps define the appropriate relationship between the State and nonprofits in Hawai`i.

Recommendations

Given that the State's interaction with the nonprofit sector spans various roles, the relationship dynamics often lack clarity and occasionally lead to inefficient and confusing outcomes. The following recommendations seek to address this issue.

(1) The State should design its relationships with nonprofits to best utilize the unique advantages of the sector. Specifically, government should utilize the nonprofit sector when one or more of the following applies:

   a. Rapidly changing community conditions, emergent issues, or other uncertainties require flexibility and innovation;
   b. Government lacks specialized local knowledge and relationships to promote program objectives;
   c. an issue would benefit from a long-term approach that is likely to extend beyond electoral cycles, and nonprofits have the resources to leverage such an effort;
   d. private funding, volunteer labor, or operating efficiencies are available to a nonprofit and could significantly reduce the cost of the program to taxpayers.

(2) Government should avoid contracting with the nonprofit sector where the only benefits are limiting growth of government employment, rewarding favored constituents or shifting operational risk from government to private agencies.

Section III: The State as Planner & Coordinator

One of the principal functions of government is to plan and coordinate delivery of social services[12] statewide. As previously noted, State government is well positioned to define the agenda for public action, and to coordinate efforts to address public problems across sectors and communities.

Currently, little planning and coordination exists between government agencies or between State agencies and the nonprofit sector related to delivery of comprehensive social services.

Government planning and coordination of service delivery is an issue that has received attention across the country. Gail C. Christopher, Executive Director of the Institute for Government Innovation recently encouraged government officials to work more collaboratively with foundations and nonprofit organizations. These sectors, she said, "have accumulated tremendous insights into the nature of disparities through the research and demonstration programs it has funded, but these will remain just insights unless they are translated into policies and their programs taken to scale." A recent report by the National Academy of Public Administration made similar recommendations.[13]

Advisory Group members and others interviewed as part of this study (see Exhibit B for list) voiced concern about the lack of State coordination and planning of social services in Hawai`i, and lack of coordination in the health and human services in particular. Many felt that having clearly articulated State goals and priorities would help reduce or avoid duplication of service, and improve planning within their organizations. State government officials expressed interest in learning from nonprofits and collaborating with private foundations to reduce duplication of services and share best practices.

At present, there is little inter-agency planning or coordination within State government regarding the provision of social services. Nor is there coordination or planning activity between the State, other levels of government, and the nonprofit sector. Interviewees familiar with the State planning process felt that coordinating service priorities and procurement processes among State agencies would increase efficiency and improve service delivery. Informants noted significant overlaps in areas of service with two or three State agencies sometimes procuring the same type of service from a single nonprofit, with little or no communication between the agencies. Even in cases where there was no duplication of services per se, interviewees felt that collaboration and integration of services between agencies would still make the procurement and delivery of services more efficient.

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[12] Social service is used here in the broadest sense to refer to provision of health, human services, education, environmental protections, etc.

[13] http://www.napawash.org/publications.html

Some of the mechanisms that exist for statewide planning are not being utilized. Developing plans with these mechanisms would help coordinate social services between State agencies, and between the State and the Counties.

In 1978 the Hawai`i State Legislature passed the Hawai`i State Planning Act, which required the State to develop a State Plan. The mandate was created "to increase the effectiveness of government and private actions," and "to improve coordination among different agencies and levels of government."[14] The State Plan was intended to guide future long-range development of the State; identify goals, objectives, policies, and priorities; provide a basis for allocating limited resources (financial, human, natural, etc.); and improve coordination of federal, state, and county plans, policies, programs, projects, and regulatory activities. The Plan was to be updated and revised regularly.

The Act also required State agencies to develop Functional Plans designed to "set forth the policies, statewide guidelines, and priorities within…specific field[s] of activity…proposed, administered, or funded by any agency of the State." "Fields of activity" included health, education, historic preservation, housing, and other social services.[15] The Functional Plans were to "identify priority issues" in the field of activity and define "objectives, policies, and implementing actions to address those priority issues." Upon approval by the Governor, Functional Plans were to "serve as guidelines for funding and implementation of programs by State and County agencies."[16]

In the early-1990s, both the State Plans and the Functional Plans fell into disuse. A State fiscal crunch strained departmental resources, and planning positions were among those cut. In addition, changes were made to planning statutes, which split responsibilities for the planning process between the Office of Planning and the Department of Budget and Finance. The changes were intended to make the Functional Plans more fiscally realistic, but combined with budget cuts, they strained Departments' ability to maintain planning efforts. Still, the statutory mandate to create and update State and Functional Plans remains. The Plans represent an untapped opportunity to articulate statewide social services priorities that could help nonprofit organizations coordinate their activities, and enhance their efficiency and effectiveness.

Tools exist to promote involvement of the nonprofit sector in planning and coordination of social services, and of health and human services in particular. Some of these mechanisms are underutilized.

The State has created vehicles to involve the nonprofit sector in planning and coordination of social services. The Functional Plan Advisory Committees (mentioned above) represent one such vehicle. The Committees were established under State law to "advise state

[14] Hawai`i Revised Statutes, Chapter 226, Section 1.
[15] Hawai`i Revised Statutes, Chapter 226, Section 2, 52.
[16] Hawai`i Revised Statutes, Chapter 226, Section 55.

agenc[ies] in preparing, implementing, monitoring, and updating the functional plan[s]..."[17] State law mandates that separate Advisory Committees be established for each Functional Plan and that the committees be comprised of officials from each county, members of the public, experts in the field of the Functional Plan, and State officials.

A second vehicle exists to involve nonprofits specifically in planning and coordinating *procurement* of health and human services. Hawai`i law directs the State Procurement Office Administrator to "assist, advise, and guide state agencies in matters relating to planning and purchasing health and human services." The same statute creates an Interagency Committee on Purchase of Health and Human Services, and a Community Council. Both bodies are designed to aid the Procurement Office Administrator in "securing input from providers to facilitate agency decision making to assess needs, plan, budget, and purchase health and human services."[18] Related Administrative Rules encourage purchasing agencies to "collaborate with providers through sharing of planning information and analysis that results in improved service specifications for purchased services and progress towards desired outcomes."[19]

The Functional Plan Advisory Committees stopped functioning at the same time that the State and Functional Plans fell into disuse. The Interagency Committee and the Community Council are available to the Procurement Office Administrator, however it is left to the Administrator's and Purchasing Officers' discretion whether or not to use these mechanisms to obtain community participation in planning. At present, the Interagency Committee and Community Council are active and involve representatives from the nonprofit sector. In general, interviewees felt that while nonprofit involvement in planning efforts had improved, both the State and nonprofits themselves could take more initiative to increase government-nonprofit coordination. Existing mechanisms thus represent an untapped opportunity to involve the nonprofit sector in the planning process and improve coordination.

Other states offer examples of how government plays an effective role in planning and coordination that enhances the ability of the nonprofit sector to pursue public aims.

- **Friends of the Family, Inc.** Friends of the Family, Inc. (FOF) is a public/private/community partnership. FOF is responsible for developing and coordinating Maryland's Family Support Initiative, a statewide preventive effort to strengthen families with children aged 0-3 years through community based, owned, and operated programs. This initiative addresses the ineffectiveness of traditional social service delivery systems to meet the comprehensive needs of families. FOF develops education and center based support services in partnership with the Governor, public agencies, communities, and private foundations to serve families who live in communities with the highest rates of abuse, neglect, child development problems, school dropout, unemployment, teen pregnancy, poverty, and family

[17] Hawai`i Revised Statutes, Chapter 226, Section 55.
[18] Hawai`i Revised Statues, Chapter 103F.
[19] Hawai`i Administrative Rules, Chapter 142, Sections 101 and 201 respectively.

dysfunction. Of equal importance to services provided is FOF's role as collaborator in the development of state policies for early intervention, systems reform, and new methods of service delivery.[20]

New York City Parks. Faced with steadily dwindling maintenance budgets as well as the impressive success of citizen-led efforts to revive some of New York City's parks, the New York City Department of Parks and Recreation embarked on a drive to increase citizen, community and private-sector support for neighborhood parks. Using a mix of public and private resources including small grants, technical assistance and community organizing, the partnerships have engaged thousands of groups in their park improvement efforts, helping to create grassroots support and neighborhood advocates for specific parks. Last year alone, the project organized four major citywide volunteer events that drew more than 20,000 participants to more than 200 sites for parks-enrichment work.

Both public/private partnerships have won national acclaim for innovatively balancing the strengths of each sector to achieve mutually agreed upon outcomes.

Recommendations

Interviews suggested that the State could improve planning and coordination of social services and increase nonprofit participation in the planning process. Specific recommendations in this area included the following.

(1) The State should comply with existing law and reintroduce regular updates of the State Plan and Functional Plans. The Plans should then be used to direct program design and procurement and should be widely shared with the nonprofit sector.

(2) The State and nonprofit leaders should work to increase involvement of nonprofits in state planning through existing mechanisms like the Functional Plan Advisory Committees, the Interagency Committee on Purchase of Health and Human Services, and the Community Council.

[20] Project descriptions taken from Innovations in American Government Program website at www.ksg.harvard.edu/innovations/home.html

Section IV: The State as Customer

One of the central areas of concern among Advisory Group members was the impact of State procurement practices upon local nonprofit organizations. The Advisory Group and interviewees noted that the structure of State contracts, payment practices, and reporting requirements place serious burdens on nonprofit agencies and threaten the viability of many smaller, community-based organizations in particular.

State contracting and payment practices have long been an area of concern among nonprofit agencies. In 2002, the Hawai`i Together Committee (a group formed to address the impact of September 11th on local social service agencies) examined the issue in great depth through its Payment & Contracts Sub-Committee. This section of our report draws heavily from their work.

Government's expanding role as nonprofit *customer* is exposing nonprofits to professionalization, more onerous government oversight, competition with business, changing nonprofit missions, and posing serious challenges for smaller organizations.

Nationwide, dependence of the nonprofit sector upon program service revenue,[21] and upon government contracts in particular, is increasing. In 1996, program service fees (the majority of which was earned through government contracts) reached 39 percent of total nonprofit revenues nationwide, becoming the sector's largest revenue source for the first time.[22] In Hawai`i, program service fees comprised 52 percent of all nonprofit revenues last year. State health and human services contracts alone amounted to over $320 million in nonprofit revenues. Increased dependence upon government contracts has had the following unintended consequences on the way nonprofits operate.

- **Competition.** Shifting nonprofits' revenue base from donations to service fees has increased competition with for-profit organizations. Having created, or newly entered, markets that can yield substantial commercial returns, nonprofits are now encountering serious competition from for-profit providers attracted to these same markets. Competition for government business has blurred the differences between the nonprofit and for-profit service providers, raising fundamental questions about the justification for tax advantages that nonprofit organizations enjoy.

- **Professionalization.** The change of nonprofits from voluntary service organizations to hired contractors has required them to meet higher standards of professionalism in order to compete. For some nonprofits, like childcare providers, this has meant that staff must be certified. For others, it has merely required a larger financial investment in professional development. Professionalization has also made

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21 Program service revenue is income earned for providing services. Most often, program service revenue is generated from contracts with state or local government, or from client fees.

22 Salamon, Lester p.223

it difficult for some nonprofits to utilize volunteers in service delivery. Organizations have had to attract and retain more highly skilled workers, and invest more in professional development. These are serious burdens considering that the nonprofit labor market that is already characterized by frequent burnout, high turnover, and limited financial resources.

- **Accountability and Reporting.** Public funds carry with them a special burden that neither private gifts nor grants create. In every case in which government funds pass to nonprofit organizations, government establishes and communicates expectations about both program design and performance that arise out of government's need for accountability and transparency. Accepting government contracts exposes nonprofits to more onerous reporting and regulatory requirements. The heightened government scrutiny and oversight can clash with the independent nature of the nonprofit sector – a tension discussed in detail in subsequent sections.

- **Changes to Nonprofit Missions.** In many instances, government contracting has induced nonprofits to modify their missions. Because government programs tend to deal with broad issues affecting the general population, while nonprofits deal with narrower issues and communities, contracts may encourage nonprofits to broaden their missions and target populations. Accepting public funds may also discourage a nonprofit from engaging in lobbying or advocacy activities that are privately supported and core to the organization's mission.[23]

- **Smaller Nonprofits Disadvantaged.** The increasing role of State contracting as a source of revenue for nonprofits places many smaller, community-based organizations at a disadvantage relative to larger, well-established organizations. Contracting raises barriers to entry for new nonprofits because State application and reporting requirements can only be shouldered by larger organizations with staff that can focus on these tasks. In addition, the structure of State payments often requires providers to cover initial program expenses, and smaller nonprofits may lack the financial capacity to do so.

Unit cost and fee-for-service contracts do not cover many start-up costs and fixed expenses borne by nonprofit providers. Such contracts also make it difficult for nonprofits to maintain capacity when client levels fluctuate.

State agencies commonly contract with nonprofit agencies on a *fee-for-service* or *unit cost* basis. Under fee-for-service contracts, nonprofit providers are reimbursed for expenses related to provision of specific services. Reimbursement is typically limited to expenses directly associated with service provision (e.g., wages of staff providing the service). Under a unit cost contract, nonprofits are paid a pre-negotiated rate per unit of service provided –

[23] Aspen Institute, Nonprofit Sector Strategy Group. The Nonprofit Sector and Government: Clarifying the Relationship (Colorado: Aspen Institute, 2000), 9.

typically measured by the number of clients served. Thus, if a nonprofit serves 50 clients, the organization is paid 50 times the unit cost rate negotiated with the State agency.

The defining feature of both unit cost and fee-for-service contracts is that they attempt to link payment to the level of service provided. Costs that vary with the level of service are therefore likely to be covered, while costs that do not vary with service are not. Fixed costs like rent, building maintenance, or administration are typically not covered under State contracts. In addition, costs associated with program start-up like planning, staff recruiting, professional development, or equipment purchases are not covered by State payments.

The absence of funding for fixed and start-up costs creates two types of problems for nonprofit organizations. First, nonprofit providers must seek alternate sources of funding to cover these program-related expenses. There are very few sources of funding – public or private – to cover core operating costs like rent or administration. Therefore, many nonprofits are forced to finance these costs and raise additional funds to cover interest expense. Charter schools regularly face this problem as they are paid by the State on a per-pupil formula that does not include many fixed, start-up, or facilities expenses.

The second problem created by unit cost and fee-for-service contracts is that nonprofits have difficulty maintaining capacity when client levels temporarily fluctuate. A short-term decline in the number of client referrals may cause dramatic changes in an organization's income level and threaten its ability to maintain the minimum level of capacity needed to provide services. For example, nonprofit agencies serving children and youth often experience temporary declines in referrals from schools during teacher strikes, reducing the organizations' revenues. During these periods, the nonprofit providers must maintain staffing and facilities adequate to provide services once referrals resume, but may lack the income needed to do so. Such fluctuations can create serious system-wide inefficiencies as nonprofits are forced to dramatically scale-up and scale-back services or, in the worst case, are forced out of business entirely by temporary changes in the number of clients served.

Most State contract payment schedules do not cover the cost of initial operating expenses. Furthermore, delays in payment threaten nonprofit operations, particularly for smaller, community-based organizations.

Most State contracts provide for payments to nonprofit providers on a monthly or quarterly basis and allow disbursement only after services have been rendered. As such, the initial cost of operating a program – from the contract signing to the first payment date – is not covered by contract payments. Larger nonprofits may be able to cover these costs with reserve funds or with other streams of income. However, many smaller, community-based nonprofits either choose not to bid for these contracts or are forced to finance initial operating expenses and fundraise to cover financing charges. Reimbursement contracts can also create problems if client levels suddenly skyrocket as happened following September 11th. During such times, nonprofits must scramble to increase staffing, facilities space, and supplies, but may lack the resources to do so if State payments come only after service is rendered.

Delays in payment under State contracts exacerbate these problems for nonprofit providers. Reports of delayed payment varied among nonprofits and between contracting State agencies. However, many nonprofits reported regular delays in payment of up to 60 days, and one organization reported delays in payment of up to 120 days. Many organizations also reported that they were forced to seek financing to cover operating expenses when State payments were delayed. One interviewee noted that obtaining financing was not easy, even for larger, well-established nonprofits because, in general, banks were conservative when it came to nonprofit lending.

National studies suggest the problem of initial and delayed payments are not unique to Hawai`i. A nationwide survey of 1,000 nonprofit executives by the Office of Management & Budget found that delayed payment affects a majority of nonprofits and impacts small, community-based nonprofits most severely. The study recommended that government programs modify payment reimbursement procedures for smaller nonprofit organizations, citing a public interest in maintaining community-based providers with intimate knowledge of and connections with the communities they serve.

Lack of standard contracting procedures and reporting requirements places serious burdens on nonprofit providers and threatens the viability of smaller, community-based organizations.

Redundant, burdensome and uncoordinated contracting and reporting requirements among federal, state and local governments create serious obstacles for many Hawai`i nonprofits, stretching the capacity of their staff. For instance, different agencies may require nonprofits to report the same financial information but in different formats and for different periods. In the most extreme cases, a single nonprofit may provide an identical service to two or more State agencies but be challenged with different Requests for Proposals, reporting requirements, data collection standards, payment terms and schedules, and even different rates of payment for the same service.

The problem is compounded by lack of coordination at the federal level. Roughly 30 percent of Hawai`i's $320 million in health and human services contracts is federal money passed through State agencies to local organizations. Different federal agencies impose different reporting requirements on the State, thus forcing State agencies to pass on the reporting requirements to local nonprofits. In 2000, the Congress passed the Federal Financial Assistance Management Improvement Act (P.L. 106-107), which mandated uniform application forms and reporting systems for federal agencies and called for a streamlined Federal grants process. The mandate has yet to be fully implemented. A recent study by the Office of Management and Budget recommended full and timely implementation of the Act directed by a team including nonprofit agencies and grants management experts.[24]

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[24] Recommendations drawn from survey sponsored by Office of Management and Budget, The Union Institute, National Committee for Responsible Philanthropy and the Advocacy Institute resulting in recommendations for President George Bush on improving the Nonprofit sector 01/20/2001

The State has begun to shift toward outcomes-based granting and contracting. While the model carries many benefits, new standards must mitigate the risks of creaming the crop, trading quality for quantity, and narrowing nonprofit missions.

In the early 1990s, a new interest in performance based contracting and outcomes funding began to sweep the country. The most visible sign of this trend at the federal level was passage of the Government Performance and Results Act of 1993. The Act required organizations receiving federal funding to create specific outcome goals and post their progress toward these goals on a regular basis.

Outcomes- or performance-based funding offers significant improvements over simple fee-for-service or unit cost models. Under the old funding mechanisms, ultimate client results or outcomes were rarely tracked because they were not the basis on which performance was measured or rewarded. Such arrangements often encouraged nonprofits to maximize inputs (e.g., hours of counseling provided) without attention to the intended program outcome. Performance-based contracting attempts to design contractual relationships that reward nonprofits for producing meaningful outcomes, while lessening emphasis on program inputs, thereby aligning incentives with intended program results.

Both the public sector and private foundations in Hawai`i have recently initiated efforts to move toward outcomes funding. While the move promises significant benefits for the nonprofit sector and the public, there are several risks inherent in performance-based funding which much be addressed in implementation. Four pitfalls deserve specific attention:

- Many nonprofits pursue complex goals like community empowerment, enhanced client self-esteem, or cultural appreciation. The work of these nonprofits may be undervalued by a system that focuses on quantifiable outcomes.

- Performance based contracting can cause 'creaming' of the client crop, encouraging nonprofits to serve only those that promise a successful outcome. For example, agencies may be encouraged to focus on training those that show the most promise of employment, or on rehabilitating those closest to recovery.

- Rewarding nonprofits based on outcome performance measures can create a perverse incentive for organizations to serve greater numbers of people, sacrificing quality for quantity and ignoring any attempts to address underlying social problems.

- The move to performance-based funding demands restructuring within nonprofit organizations and can cause confusion and anxiety among both nonprofit staff and State compliance officers. One State official observed the need for more training of state monitors and nonprofits around performance-based contracting.

Examples of best practices in performance- and outcomes-based contracting in other states provide important lessons for Hawai`i.

- **Milestone Contracting in Oklahoma.** [25] In 1991, Oklahoma implemented a program to train disabled adults to work in integrated jobs in their communities. The program proved very expensive, suffering from the agency's fee-for-service reimbursement structure, which put too much emphasis on providing services – skills assessments, job training, supervision all billed on an hourly basis – at the expense of moving the clients as quickly as possible into stable jobs.

  In response, Oklahoma designed a new system called Milestones, which reimbursed nonprofits when clients reached each of a series of steps—the "milestones"—along the way to permanent employment. The milestones included indicators such as job retention, wages, and employer and client satisfaction. Milestones would reimburse the nonprofit for the "average" cost of providing the service based upon a survey of providers from the previous year, rather than paying hourly for staff time. In order to encourage the nonprofits to make good matches, the organization would only be paid once for each milestone. In order to combat "creaming of the crop" Milestones created a two-tiered system of payments through which service providers would be paid higher fees for serving people designated as "highly challenged." State officials worked with nonprofits, involving them in the design of the program and definition of the milestone and outcome measures.

  A few key lessons emerge from the Milestones example. The success of Milestones required extensive consultation on the part of the agency with the managers and job coaches. The two-tiered reimbursement system prevents client creaming. The decision to set reimbursements at the average cost of a service was also crucial, giving the nonprofits incentives to root out inefficiencies within their organizations and continually reduce the cost of service. Finally, by making the final payment the largest one and by making it only apply to real work in the community, Milestones encouraged the nonprofits to not waste time on intermediate inputs and focus on the ultimate outcome – a lasting job placement.

- **Oregon Benchmarks.**[26] Seven years ago, Oregon's governor asked groups of people from all over the state to advise State officials on Oregon's future. After a lengthy process, the groups concluded that by the year 2010, Oregon should have achieved three strategic goals: the best educated and prepared work force, maintaining the state's natural environment and uncongested way of life, and a diverse, internationally oriented economy paying high wages.

  Soon after the three goals were announced in 1989, the Oregon Progress Board released its first 158 Benchmarks in 1991. Within six months, the legislature had unanimously adopted these measures and directed the Progress Board to update

[25] Peter Frumkin, Balancing Public Accountability and Nonprofit Autonomy, Milestone Contracting in Oklahoma, JFK School of Government, Hauser Center, 2001.
[26] Project descriptions taken from Innovations in American Government Program website at www.ksg.harvard.edu/innovations/home.html

them every two years. By 1993 the number of benchmarks had expanded to 272, including 43 classified as critical.

Benchmarks do not measure progress by such standards as the number of programs created, budget dollars expended, or clients served. Instead it focuses on measuring specific outcomes in dozens of specific areas--all related to accomplishing the three main objectives for the state. Benchmarks has succeeded in providing a clearer framework for engaging people both inside and outside government in the pursuit of well-defined objectives. Interim goals are established for intervening years. Targets are set in areas ranging from reducing violent crime to raising adult literacy levels to increasing the miles of Oregon rivers and streams that meet state and federal water quality standards.

One unexpected result of Benchmarks is the degree to which it has fostered cooperation among government agencies and between the public and private sectors. State officials concede improvements are still needed. Data gathering for some benchmarks remains insufficient.

Notably, this program provided the underpinning for many of the current efforts of Hawaii's Performance Partnership Board.

Recommendations

Concerns about the State's impact as a customer of nonprofit services were widespread. These concerns focused primarily on the State's contracting and payment practices. The recommendations to follow draw from and add to those of the Hawai`i Together Payments and Contracts Sub-Committee which explored many of these same issues.

(1) Provide an initial payment at contract signing to cover initial operating expenses

(2) Guarantee a minimum payment level adequate to maintain a minimum level of capacity even through temporary fluctuations in the number of clients

(3) Structure payments to provide profit adequate to support capacity building or provide specific grant funding for this purpose

(4) Explore contract set-asides and modified payment schedules to allow smaller, community-based nonprofits to participate in State contracting.

(5) Coordinate reporting requirements between State agencies, creating standard forms and schedules to the maximum extent feasible

(6) Structure performance-based contract payments to mitigate the risks inherent in such contracting (e.g., combat creaming by paying more for hard-to-serve clients).

Section V: The State as Business Support Provider

Although not specifically articulated by the Advisory Group, conversations with local and national nonprofit leaders generated discussion of State business supports for the nonprofit sector. Business supports are defined as programs, incentives, or other forms of assistance designed to increase the organizational capacity of nonprofits and promote the growth and health of the industry. In its efforts to create a healthy local economy, the State plays a significant role as a supporter of business in most industries and sectors such as the hotels, agriculture, and high technology[27]. Acting in this role, the State also provides general business supports designed to support entrepreneurs and help start and grow small businesses.

Despite its important contributions to the economy, business supports for the nonprofit sector are lacking.

As previously noted, the nonprofit sector is an important contributor to the local economy, representing the 4th largest employer among the sectors and outperforming most industries in terms of employment and revenue growth over the past decade. Yet, in spite of its economic importance, business and industry supports for the nonprofit sector are lacking. Although the sector is larger (in terms of employment and payroll) than agriculture, manufacturing, and high technology, the State has invested seriously in business development programs for these industries, while no such supports exist for the nonprofit sector.

For instance, the state's agriculture industry is about one-half the size of the nonprofit sector, and has won a variety of business supports like State agricultural parks that provide low-cost land and infrastructure for farming, agricultural extension programs that provide business- and farming-related technical assistance, and special State loan programs and marketing supports. The high tech sector similarly benefits from special tax incentives, business incubators, business accelerators, and special financing programs, although it represents just 2 percent of total employment (compared to the nonprofit sector's 9 percent). The point is not that these industries are unimportant or undeserving of State support. Rather, the point is that business supports should be available to nonprofits, given the sector's relative importance to the local economy.

Nonprofits lack access to a range of existing business assistance programs and industry supports.

[27] Note that we distinguish between business/industry supports and funding or contracting with nonprofits. Grants and contracts reflect government's interest in addressing particular public needs or providing a particular set of public services. Government's role as an industry supporter instead reflects its interest in economic development through support of business and industry.

Nearly all nonprofits in Hawai`i fall within the definition of 'small business' used by most State and federal agencies: fewer than 25 employees or $5 million in annual revenues. Most nonprofits also share many of the challenges faced by small businesses: the need to develop good business plans, access to capital for start-up or expansion, hiring and retention of employees, etc. Unlike other small businesses, though, nonprofits lack access to existing business support programs.

For example, the State-supported Small Business Development Centers provide business planning assistance, management training, and referral services to entrepreneurs, but do not provide these services to nonprofit organizations. Government loan guarantees and other credit programs like the SBA's 7a Loan Guarantee Program exist to help provide small businesses obtain access to capital. Nonprofits, too, require capital to purchase equipment, improve facilities, or finance start-up costs, but they are not eligible under existing credit programs. Similarly, tax incentives designed to encourage businesses to invest in R&D or new technology benefit many for-profit firms, but are not applicable to the already-exempt nonprofit sector.

Few sources of funding exist to support building nonprofit business capacity. Lack of funding for capacity building limits the ability of nonprofits to increase efficiency and improve the quality of services.

Building core business capacity is no less important in the nonprofit sector than in the for-profit sector. Activities like professional development, system upgrades, research and development, and strategic planning work to enhance overall organizational effectiveness and lead to increased efficiency and improvements in quality of service.

Even without State-sponsored business and industry support programs, for-profit businesses can develop their own capacity by investing profits back into the business. However, most nonprofit organizations do not have this option. Sources of funding and support for these activities within nonprofits are in extremely short supply. In the interest of maximizing accountability and limiting profit, government contracts are structured to limit payment as strictly as possible to provision of services. Most private funding is similarly restricted to programs and services. Without a profit margin or a source of funding dedicated to capacity building, nonprofits cannot invest in organizational improvement.

In the absence of State business and industry supports for the nonprofit sector, private foundations and the nonprofit sector itself have begun to develop some assistance programs.

In the absence of public supports for the nonprofit industry, private foundations and select members of Hawai`i's nonprofit community have begun to initiate efforts to promote the health of the industry. In 2001, the Hawai`i Community Foundation convened a group of private consultants and technical assistance providers in an effort to train them to work more effectively with nonprofits. The Foundation also created a grants program targeted specifically to helping nonprofits build organizational capacity. However, this remains one of the few sources of support in this area for nonprofits. Some nonprofit organizations have begun to provide technical assistance and training to other nonprofit organizations. Examples include the Hawai`i Alliance for Community Based Economic Development, the Hawai`i Community Services Council, and Volunteer Legal Services of Hawai`i. There is also a proposal, currently under consideration by the State Legislature, to create a resource center that would serve as a clearinghouse of information and central source of support for nonprofit organizations statewide.

Recommendations

While other industries receive specific business supports from the State, the nonprofit sector does not, despite its economic importance. The following recommendations speak to the need for nonprofit business and industry supports.

(1) Existing, State-supported business and industry assistance programs should be made available to the nonprofit sector. Alternatively, the State should explore ways to work with emerging providers of business assistance to the nonprofit sector.

(2) The State should make an investment in business supports for the nonprofit sector commensurate with the sector's importance to the local economy. It should explore ways to make supports available through tax incentives applicable to the nonprofit sector; and investigate the costs and benefits of creating industry-specific support programs.

Section VI: State Regulation & Taxation

State and federal governments confer public subsidies to the nonprofit sector in the form of tax breaks for nonprofit organizations and tax deductions that encourage donations. In return, governments expect that nonprofit activities serve a publicly-desirable purpose. As such, government plays an important role in ensuring that tax exempt entities are providing their promised public benefits and maintaining standards of financial accountability.

Although the State serves as a regulator of the nonprofit sector in this regard, it has difficulty maintaining quality control with organizations that do not receive public dollars directly through State contracts or grants. At best, it can ensure that nonprofits conform with guidelines from the Internal Revenue Service by demanding internal audits and conform to general laws and regulations affecting all Hawai`i businesses.

Regulation is increasingly challenging the State. Measuring and monitoring public benefits or the quality of services provided is particularly difficult. Government pays the cost of healthcare for Medicaid patients, but has difficulty accounting for the quality of care.

The new Nonprofit Corporations Act is the central legal instrument affecting nonprofit organizations in Hawai`i. The law governs many aspects of nonprofit operation.

The central instrument of the State governing nonprofit activities is the new Nonprofit Corporations Act, which was adopted in 2001 and took effect in July of 2002. Codified in Chapter 414D of the Hawai`i Revised Statutes the law introduces some significant changes to the old Nonprofit Corporations Act and closely follows the Revised Model Nonprofit Corporations Act of the American Bar Association. Provisions of the New Act are also designed to parallel the Hawai`i Business Corporations Act simplifying regulation for the Department of Commerce and Consumer Affairs. The new nonprofit law governs virtually every aspect of nonprofit operations – from the procedures and fees for filing corporate documents to the requirements of member meetings. Only those provisions with the most significant impact upon Hawai`i's nonprofit organizations are discussed here.

- Membership & Member Rights. The new Act requires that nonprofits state in their articles of incorporation whether or not they will have members. Articles and bylaws must also set forth the criteria for membership and the procedure for admission.[28] Unless an organization's articles and bylaws provide otherwise, all members have equal voting rights and 10 percent of total membership constitutes a quorum.[29] A

[28] HRS Section 414D-110.
[29] HRS Section 414D-111.

member may request a court-ordered membership meeting to be held if an annual meeting has not been held within the past 15 months.[30]

- Director Appointment and Removal. The law requires that every nonprofit have at least 3 directors elected by members (if a membership organization) or by the nonprofit's board (if a non-member organization).[31] Directors' terms are limited to 5 years. Directors elected by members may be removed by the members without cause provided that the number of votes required for removal is the same as the number required to elect the director. In the case of a Board election, two-thirds of the Board members are required for director removal.[32] The New Act also specifically provides that an organization's articles or bylaws can provide for the removal of a director for missing a specified number of meetings.[33]

- Standard of Conduct. Standard of conduct for directors and officers of nonprofit corporations is the same as for business corporations. Under the law, directors and officers must act in good faith; act with the same care an ordinarily prudent person would use in a similar situation; and act in ways believed to be in the best interest of the corporation.[34]

- Director and Officer Liability. The law limits the liability of directors and officers in certain ways. Directors or officers who serve without remuneration are not liable for breaches of the standard of conduct unless gross negligence is involved.[35] Articles and bylaws may further limit or even eliminate entirely the personal liability of a director to the corporation or its members. However liability cannot be eliminated if a director breaches duty of loyalty to the corporation, knowingly violates the law, personally gains from an organizational transaction, or acted with a conflict of interest.[36] The law also authorizes nonprofits to purchase insurance for liability incurred by directors, officers, employees, or agents.[37]

- Mandatory Indemnification. Unless otherwise specified in its articles or bylaws, a nonprofit must indemnify a director who was successful in the defense of any proceeding to which the director was party. The court may also order indemnification at the request of a director if the court finds that the director is entitled to mandatory indemnification under the law.[38]

- Emergency Decision Making. The new law includes provisions that authorize nonprofits to take certain actions in the event they are not able to assemble a quorum of board members due to a catastrophic event. The law states that notice need only be given to those directors it is practical to reach and may be given in any

[30] HRS Section 414D-103.
[31] HRS Section 414D-133.
[32] HRS Section 414D-134.
[33] HRS Section 414D-138(i).
[34] HRS Section 414D-221(a).
[35] HRS Section 414D-149(f).
[36] HRS Section 414D-32.
[37] HRS Section 414D-166.
[38] HRS Section 414D-161.

practical manner. A nonprofit board may also change succession procedures or relocate the organization's official principal office during an emergency. Under the new law, a nonprofit may also adopt special bylaws to be effective only during an emergency.[39]

- Corporate Books and Records. The new act spells out in greater detail than the old act the books and records required to be kept by nonprofits. Nonprofit corporations must keep, at their principal office, their: articles of incorporation and all effective amendments; bylaws and all effective amendments; board resolutions relating to qualifications, rights, limitations and obligations of membership; minutes of all meetings of members; records of all actions approved by the members for the past three years; a list of the names and addresses of current directors and officers; a list of current members; the most recent annual report filed with the Department of Commerce and Consumer Affairs; IRS application for tax-exempt status (if applicable); and tax returns for the past three years.[40]

The new Nonprofit Corporations Act has been generally well received by those familiar with it. However the new law is still not well known or understood by many in the nonprofit sector.

Interviewees familiar with the new Nonprofit Corporations Act and with the nonprofit sector felt it introduced some improvements over the old statute. New provisions spelling out default procedures for director election and removal were lauded as was the granting of special decision-making powers during the event of an emergency. Some noted that the emergency powers provisions were particularly appropriate since nonprofits are often among those to respond to crisis events.

The Act contains more detailed requirements for membership meetings of membership-based nonprofit organizations; more specific rules about the election and removal of directors and officers; and indemnification of volunteers under certain circumstances. The new law also allows nonprofits to take certain action without a quorum of directors in the case of an emergency or catastrophic event.

There were few complaints or concerns voiced about the new Nonprofit Corporations Act by those interviewed as part of this study. Some observed that it imposed new costs upon nonprofits because changes to the law require nonprofits to have an attorney review and revise their By Laws and Articles of Incorporation. Others noted that the new member rights and membership meeting requirements added new complexities and risks for membership-based organizations. Membership-based organizations must exercise caution in how they define members and how and when membership meetings are conducted.

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[39] HRS Section 414D-53.
[40] HRS Section 414D-301.

Many interviewees did voice concern that the changes to the law were still not well known or understood by those in the sector. Smaller, community-based nonprofits and membership-based organizations in particular are probably still unaware that many of the legal requirements affecting them have changed. Despite efforts of some local law firms and sector advocates to provide information on the new Act, awareness is still limited.

Nonprofits are also affected by the same laws and regulations that affect all Hawai`i businesses. These laws can have a disparate impact on nonprofits, whose operations differ from that of for-profit entities.

Nonprofit organizations are affected by most of the same laws and regulations that affects all businesses. These include laws governing employment and labor issues e.g., wage and hour laws[41] and mandated benefits.[42] Furthermore, nonprofits must comply with business registration and nonprofit corporate governance laws, as well as the general laws of Hawai`i relating to issues of liability, health and safety, crime and so forth. However, because of the unique nature of nonprofit enterprises, the nexus of corporate regulation can have a disparate impact on nonprofit entities.

For example, tort liability laws can seriously affect nonprofit organizations, many of which are dependent upon volunteers to serve on Boards and deliver services. State mandates that employers carry particular kinds of insurance or provide certain benefits can be especially burdensome for nonprofits which are typically strained for the unrestricted resources needed to cover such expenses.

Several proposals are currently under consideration by the 22nd Legislature to provide relief to nonprofits from the impact of general business laws and regulations. One proposal would mandate that the Hawai`i Employers Mutual Insurance Company provide affordable General Liability and Property insurance to nonprofits (in addition to Worker's Compensation Insurance for which it was first created).[43] Another proposal requires insurance companies to offer business automobile coverage for nonprofit employees or volunteers that use their cars for nonprofit work. Still other proposals would make the State liable for damages from auto accidents involving nonprofit employees or volunteers providing services under State contract.

In the event that such relief cannot be provided, interviewees emphasized that at the very least, existing regulatory and reporting requirements should not be increased. In particular, additional financial reporting requirements, which have been considered in the past, should not be imposed since IRS 990 reports for most nonprofits are now widely available via the

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[41] Payment of Wages Law, Haw. Rev. Stat. Chapter 388; Wage and Hour Law, Haw. Rev. Stat. Chapter 387; and the Federal Fair Labor Standards Act, 29 U.S.C. 201 et seq.)

[42] Employment Security Law, Haw. Rev. Stat. Chapter 383; Workers Compensation Law, Haw. Rev. Stat. Chapter 386; Temporary Disability Law, Haw. Rev. Stat. Chapter 392; and the Prepaid Health Care Act, Haw. Rev. Stat. Chapter 393.

[43] State of Hawai`i, 22nd Legislature, Senate Bill 904.

Internet and efforts are underway to have the IRS share information on denials and revocations of charities' tax exempt status.[44]

Changes in the sector are making it increasingly difficult for State government to make effective tax policy with respect to nonprofits.

State and federal governments provide tremendous indirect support to the non-profit industry in the form of tax benefits and incentives. Indeed, federal and State tax policies supply the lifeblood of the nonprofit industry. These policies provide individual tax deductions for charitable donations and contributions, exempt nonprofits from paying taxes, and allow governments to issue tax-exempt bonds to finance projects of private nonprofits like hospitals or schools. Although quantifying the benefit of tax policies to the sector is difficult; economic research estimates that removing the tax deduction from the tax code would cause charitable contributions to drop by up to 25 percent.[45]

The effect of tax policy on nonprofits and state governments is complex. Sometimes, changes to the tax code have unintended consequences, like encouraging for-profit enterprises to shelter income by incorporating a nonprofit entity. Nonprofits are also extremely susceptible to changes in the tax code. For instance, broadening the tax base while lowering tax rates effectively reduces the relative size of the subsidy value of deducting and may therefore reduce giving.

New issues in taxation are also emerging. Some localities are increasingly frustrated by their lost property tax revenue from large nonprofit landowners. Some localities use zoning to combat this problem; others seek 'payments in lieu of taxes' as in the case of the City of Cambridge, Massachusetts which receives millions of dollars in compensation from Harvard University. The growing cadre of hybrid nonprofit/for-profit entities also challenges State and federal agencies to determine which activities are taxable and which exempt.

Hawai`i's State government has only just begun to grapple with many of these complexities. Proposals being entertained by the 22nd Legislature include a dollar for dollar tax credit for contributions to nonprofits that provide direct services to the public. The measure is intended to provide nonprofits with relief from anticipated state and federal government cutbacks in the social services. Another proposal would completely exempt nonprofits from General Excise. At present, income derived from activities not directly related to the nonprofit's social purpose are taxed, even if proceeds are designed to benefit nonprofit programs (e.g., huli huli chicken fundraisers, sale of donated automobiles, etc.). Finally, the State is also exploring expanded bond financing authority to support development of nonprofit facilities.

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44 U.S. Government Accounting Office, "Tax-Exempt Organizations: Improvements Possible in Public, IRS, and State Oversight of Charities," Washington D.C.: U.S. G.P.O., April, 2001, p 1.
45 Brody and Cortes, 147.

Recommendations

State regulations and tax policies have a variety of complex affects upon nonprofit organizations. In some cases, initiatives to increase nonprofit understanding of regulatory requirements is needed. In others, relief from regulatory or tax burdens may be appropriate.

(1) Consider providing relief from some of the general business laws and regulations that have a disparate affect on nonprofits such as insurance coverage for use of automobiles by volunteers.

(2) Consider providing the same regulatory relief to nonprofits that are provided to all small businesses, such as expansion of access to affordable General Liability and Property insurance from the Hawai`i Employers' Mutual Insurance Company.

(3) Provide State-sponsored workshops or other information on the new Nonprofit Corporations Act to Hawai`i nonprofits.

(4) Consider exempting all nonprofit income from the State General Excise Tax, provided such income is to be used for furtherance of the charitable purpose for which the nonprofit was established. Evaluate the cost to the State in foregone taxes and regulation that would be required.

Conclusion

Creating State policies with respect to the nonprofit sector is an increasingly challenging task. Like other states across the country, Hawai`i is growing ever more dependent upon nonprofits to provide services under contract with the State. At the same time, State government is grappling with new types of nonprofits that blur the line between business and charity; and new needs within the sector that demand government response. Changes within the nonprofit arena are defying the logic of old policies and creating the need for inventive new ones.

Making effective policy under such circumstances requires clear thinking about the appropriate role of government with respect to nonprofits. It also requires and a precise understanding of the issues at play in the four major areas where the State and nonprofits interact: planning and coordination of social services; government-nonprofit contracting; government-sponsored business and industry supports; and the realm of regulation and taxation. We hope this report provides some guidance in these areas and ultimately that it helps the State create policy which work to the benefit of government, the nonprofit sector, and Hawai`i's communities.

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The Alliance for Nonprofit Management: http://www.allianceonline.org/default.htm

The Urban Institute, Center on Nonprofits & Philanthropy: http://www.urban.org/content/PolicyCenters/NonprofitsandPhilanthropy/Overview.htm

Disseminated questions via the arnova (Association for Research on Nonprofit Organizations and Voluntary Action) listserve: http://www.arnova.org/list_srv.html

The National Council for Nonprofit Organizations: http://www.ncna.org/

APPENDIX A
Interviews Conducted

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APPENDIX C
The Research Team

THE HAWAI`I COMMUNITY SERVICES COUNCIL ("HCSC") works with public, private, and non-profit organizations to improve systems for planning, delivering and managing community resources. HCSC offers training and technical assistance to non-profits and community groups to improve their management effectiveness. It also incubates new projects and agencies and offers information, tools, and workshops to support community-based planning. The Council strives to be a leading broker of information and resources, to bridge sectors, and to build the capacity of Hawai`i's communities.

**THE HAWAI`I INSTITUTE FOR PUBLIC AFFAIRS** ("HIPA") is a nonprofit, nonpartisan, and independent research and educational organization whose mission is to provide research, analysis and recommendations on public policy issues facing Hawai`i, and to provide opportunities for individuals to develop as productive leaders and citizens in society. HIPA's Center for Public Policy concentrates on public policy analysis and implementation to enable decision-makers to make sound policies that benefit Hawai`i. Beyond just providing research briefs and issue papers, the Center strives to provide a neutral and supportive forum for key stakeholders and communities to implement policy recommendations outlined in reports.

ALEX HARRIS, MPP was co-lead investigator for this study. He coordinates state policy for Good Beginnings Alliance, Hawai`i's early childhood intermediary organization. His professional experience is in K-12 education reform, both at the federal level where he worked on pieces of the No Child Left Behind legislation, and at the local level, where he ran a nonprofit in a New York City high school. Alex's interests span education, juvenile justice, economic development, and nonprofit management. Alex recently received his Masters in Public Policy from Harvard University's John F. Kennedy School of Government and his Bachelor's from Brown University.

JAMES KOSHIBA, MPP was co-lead investigator for this study. He is co-founder and Principal of 3Point Consulting, a mission-driven consulting company that works to enhance the social impact of its clients. Prior to founding 3Point, he worked with several nonprofit Community Development Financial Institutions to increase investment and economic development in low-income communities. He has worked with a variety of government and nonprofit agencies in Massachusetts and Hawai`i on issues ranging from poverty and education to job training and economic development. He has also held positions as an Analyst for the Hawai`i State Auditor and as Committee Clerk for the House Judiciary Committee of the Hawai`i State Legislature. James graduated Phi Beta Kappa from Brown University and earned a Master's in Public Policy from the John F. Kennedy School of Government at Harvard University.