



# Background Briefing Paper

Categorising Costs of Human Services

# **Categorising Direct and Indirect Costs in Human Services Funding Proposals – for use by ACT Government and by Non-Government Organisations**

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# Background

The Non-Profit starvation cycle was acknowledged in the ACT Government Response to the Counting the Costs Report and Recommendations in 2023. This Response described the starvation cycle as a:

...worldwide phenomenon of deeply ingrained behaviours based on three intertwined factors:

- A. Funders have an inaccurate understanding of true cost.
- B. NFPs feel pressure to conform – especially given a power imbalance between grantor and grantee.
- C. NFPs sacrificing funding for organisational infrastructure (e.g., staffing, information technology, finance, governance). (p 11)

This Response also acknowledged:

An ongoing practice of funding that does not cover full costs leads to reduced liquidity, capacity and infrastructure; failure to adapt and innovate; lack of resilience and inability to meet demand. Research shows that Australian businesses on average spend on indirect costs 1.8–3.6 times more per employee than NFP organisations. This leaves NFPs both less efficient and more vulnerable to external shocks. (p. 11)

Enacting a consistent approach to categorising direct and indirect costs of service delivery, and assessing whether the costs included in funding proposals is one way the ACT Government can progress the following recommendations in the Counting the Costs Report that have been accepted in-principle:

## **Recommendation 2- Review ACT funding streams to ensure full cost coverage**

Adjusting the indexation formula will not rectify the gaps which are ‘baked into’ existing funding levels. Without boosting funding levels, under-resourcing will be perpetuated. Funding and contract duration should be sufficient to cover costs of:

- qualified staff recruited and retained at classification levels suited to job tasks
- professional development, supervision and other supports which develop quality and enable career progression
- reporting; administration; technology; innovation, planning and service improvement; auditing, legal and other necessary business activities, and infrastructure
- co-design and involving people with lived experience
- advocacy, consultation, and policy input
- evaluation.

The shift to a commissioning approach in the ACT is an important development and the full costs of adjusting to and participating in this new approach should be anticipated and covered.

## **Recommendation 4 - Build sector capacity to accurately cost services**

Building capacity to accurately cost services will help ensure any unfunded expenses are identified and accounted for. Smaller organisations are particularly likely to benefit from access to expertise to support accurate costings, and from sharing skills, processes, and systems for costing services. Importantly, organisations need to signal the true costs of service delivery to government, including their overhead costs, and ensure these are reflected in funding applications.

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# Evidence Base Informing Draft Materials on Categorising Costs

## Non-Profit Starvation Cycle

Full articulation of costs of human services including the indirect costs that support direct delivery of services, and full recovery of costs through funding arrangements, have been issues of concern to non-profit organisations for a least two decades, with early discussion of the causes and impacts of underfunding non-profits articulated in Rand Foundation papers in the 1990s.

Bridgespan Group in the USA conducted research during the 2000s and found that “insufficient government payments” of indirect costs frequently prevented nonprofits from covering their full program costs. In 2013, a follow-up survey touched on a broader range of sectors (most except hospitals and higher education), finding that insufficient cost recovery was most problematic among human-services providers.<sup>1</sup>

Funders (government and philanthropic) had adopted low “indirect costs” (also known as “overheads”) as a metric of efficiency in the mid 2000s.

The overhead cost ratio has been increasingly used as a de facto proxy for nonprofit efficiency and comparative effectiveness (Ashley & Van Slyke, 2012; Lecy & Searing, 2014). In the absence of meaningful tools to evaluate effectiveness, donors have relied on the overhead cost ratio to identify and compare nonprofits that make the most efficient use of resources. A lower overhead has been considered an indicator of higher organizational efficiency. Consequently, donors have utilized the ratio to hold nonprofits accountable as stewards for their contributions.

Scholars and practitioners have lamented the undue reliance on the ratio contending that a low overhead does not imply organizational efficiency or effectiveness (Bowman, 2006; Coupet & Berrett, 2019; Hager & Greenlee, 2004). A nonprofit with higher overhead could be more effective than a nonprofit with lower overhead (Crutchfield & Grant, 2008). As Mitchell and Calabrese (2019) argue, the overhead cost ratio lacks the predictive and construct validity that justifies using it as a proxy for organizational efficiency and effectiveness.<sup>2</sup>

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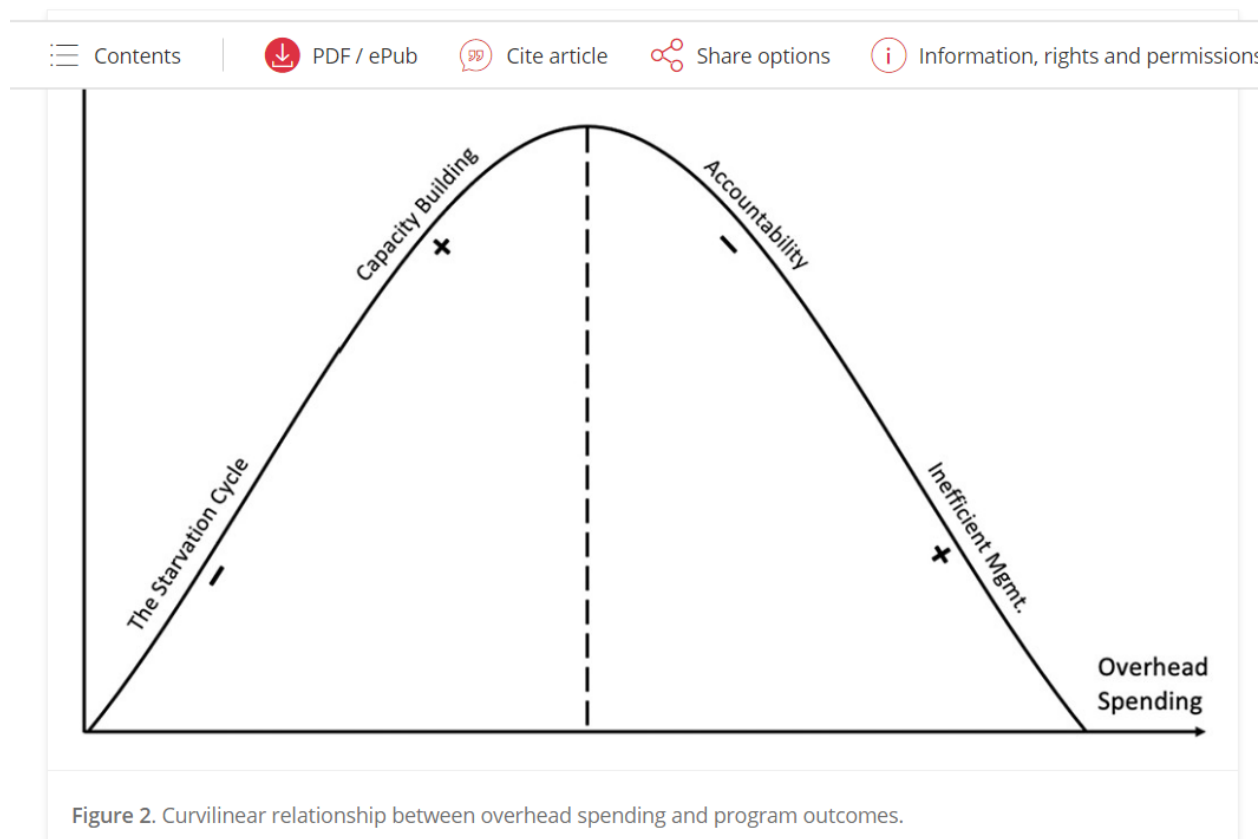
<sup>1</sup> Momentum for Change: Ending the Nonprofit Starvation Cycle (bridgespan.org) referring to Elizabeth T. Boris, Erwin de Leon, Katie Roeger, and Milena Nikolova, Human Service Nonprofits and Government Collaboration: Findings from the 2010 National Survey of Nonprofit Government Contracting and Grants, Urban Institute, October 2010, <http://webarchive.urban.org/publications/412227.html>

<sup>2</sup> The Nonprofit Starvation Cycle: Does Overhead Spending Really Impact Program Outcomes? - Hala Altamimi, Qiaozhen Liu, 2022 (sagepub.com)



This research considered the evidence for and against use of indirect costs as a measure of organisation effectiveness in the arts sector, and found:

...overhead has an optimal level



...Too little overhead is inimical to outcomes because it deprives nonprofits of resources critical for their capacity-building needs, thereby hurting their performance and long-term success. Equally, too much overhead is detrimental to outcomes because it breeds inefficiency and opens the door for resource exploitation and other agency problems...

...[the research finding] confirm the existence of the starvation cycle ([Lecy & Searing, 2014](#); [Schubert & Boenigk, 2019](#)) and add evidence supporting the cycle's central argument that underinvesting in overhead hurts nonprofit capacity and effectiveness. The left tail of the inverted U-curve in [Figure 2](#) shows that the overhead cost ratio and program outcomes are positively correlated. In other words, before reaching the optimal point, cutting overhead would inevitably compromise program outcomes...

... The optimal points are likely to vary depending on several factors. For instance, our findings indicate that paid programs demand higher overhead spending than free programs to reach optimal outcomes. Other factors, such as subsector and growth stage, are all expected to influence the optimal levels of overhead spending ([Chikoto & Neely, 2014](#)). Instead, the purpose of the optimal points is to challenge the unrealistic expectations surrounding overhead spending and join the ongoing efforts of nonprofit leaders, scholars, and charity monitors to end the overhead myth and focus donor attention on results...

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In 2009 the Stanford Social Innovation Review published an article that described a phenomenon called the Non-Profit Starvation Cycle. This article reported:

Organizations that build robust infrastructure—which includes sturdy information technology systems, financial systems, skills training, fundraising processes, and other essential overhead—are more likely to succeed than those that do not. This is not news, and nonprofits are no exception to the rule.

Yet it is also not news that most nonprofits do not spend enough money on overhead...

... underfunding overhead can have disastrous effects, finds the Nonprofit Overhead Cost Study, a five year research project conducted by the Urban Institute's National Center for Charitable Statistics and the Center on Philanthropy at Indiana University...

...Among their many dismaying findings: nonfunctioning computers, staff members who lacked the training needed for their positions, and, in one instance, furniture so old and beaten down that the movers refused to move it. The effects of such limited overhead investment are felt far beyond the office: nonfunctioning computers cannot track program outcomes and show what is working and what is not; poorly trained staff cannot deliver quality services to beneficiaries...

... decreasing already austere overhead spending (also called *indirect expenses*) may jeopardize organizations' very existence—not to mention their ability to fulfill their missions...<sup>3</sup>

One impact of the starvation cycle is NGOs are unable to fully recover all costs of service delivery. Research conducted in 2022 including organisations operating in Asia, Africa and Europe found that:

Overall, weaknesses in the cost recovery capabilities of many of the participating NGOs leave them inadequately equipped to achieve as much cost recovery as possible from their grant funding. This may be a consequence of the starvation cycle which leads to under-resourcing of the strategic financial management and cost recovery skills of the finance team, as well as other leaders and managers. Therefore, it is a poverty trap that will presumably continue until NGOs can secure the funds needed to improve their cost recovery capabilities, either from restricted funders willing to directly fund investments in their capacity, or from unrestricted funds.<sup>4</sup>

The starvation cycle has both accelerated and escalated in the ACT over the past several years, as a result of a range of factors:

- Social, Economic and Environmental disruption: The COVID-19 Pandemic, extreme weather events, global conflict and uncertainty
- Drivers of demand for NGO delivered human services: Population growth and diversification, increases in Costs of Living, increased mental ill-health, increased complexity of needs
- Increasing costs to operate and govern NGOs: workforce, insurance, cyber security, WH&S, consumer protections/safeguarding, facilities, transport, consumables
- Uncertain revenue from all sources: government, philanthropic, fee for service
- Disruption to human services ecosystem: planned and unplanned

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<sup>3</sup> [The Nonprofit Starvation Cycle \(ssir.org\)](https://ssir.org)

<sup>4</sup> <https://humentum.org/wp-content/uploads/2022/03/Humentum-ACR-Research-Report-FINAL.pdf>

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Counteracting and ceasing the starvation cycle requires action by all contributors to the human services ecosystem and over time.

Research published in 2020 recommended the following:

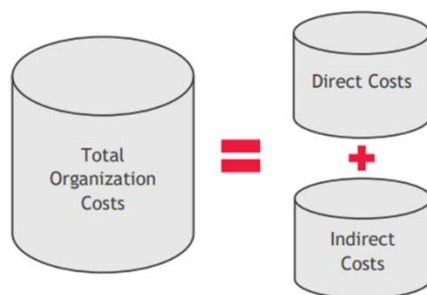
breaking the starvation cycle should focus on the roots of the cycle; that is, to overcome donors' overhead aversion, the solution might lie in alleviating information asymmetry and monitoring issues. Based upon agency theory and the existing literature, we argue that breaking the nonprofit starvation cycle could start with nonprofits providing more information to respond to the concerns that donors might have when they are aware of high overhead ratios<sup>5</sup>

## Defining Direct and Indirect Costs

Human services delivery incurs both direct and indirect costs. The figure below explains the differences between these costs<sup>6</sup>.

### TOTAL COST

The total costs of an organization comprise direct costs and indirect costs. The following definitions may be used to categorize costs as direct or indirect.



### DEFINITION

Costs that can be specifically associated with the organization's programmatic activities or allocated to such activities relatively easily and with a high degree of accuracy.

Costs incurred for a common or joint purpose benefitting more than one program and not readily assignable to the program(s) without effort (disproportionate to the results achieved).

Another definition relevant to a consideration of direct and indirect costs is the term overhead which is:

Generally understood as administrative costs. Not an adequate substitute for the term "indirect costs," which is more expansive<sup>7</sup>

Social Ventures Australia included the following guidance on cost categorisation<sup>8</sup>:

Direct costs are those costs that are specific to a project, such as, salaries for project staff and materials required for the project. The key test is that these costs would not be incurred if the project being funded did not exist. For example, staff time that can be unambiguously identified as having been spent on the project or travel costs for project travel...

...Shared costs are those costs that benefit multiple programs or projects and can be allocated across programs or projects in a reasonably consistent and accurate way. These costs are just as integral to the delivery of the project as the direct costs.

<sup>5</sup> [\(PDF\) Breaking the nonprofit starvation cycle? An experimental test \(researchgate.net\)](#)

<sup>6</sup> [Fundors for Real Cost, Real Change \(squarespace.com\)](#)

<sup>7</sup> p 5 [Momentum for Change: Ending the Nonprofit Starvation Cycle \(bridgespan.org\)](#)

<sup>8</sup> pp13-14 [Paying what it takes: Funding indirect costs to create long-term impact \(socialventures.com.au\)](#)

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Generally non-personnel costs, these costs can include office costs and facilities, utilities, telephone and internet access that can be clearly attributed to a person working on a specific direct cost project. Depending on how an organisation is structured, some quality, training, and measurement and evaluation costs may also be classed as shared costs. Note also that shared costs in some organisations and studies are described as an indirect cost...

...Indirect costs are costs for activities or services that support the organisation as a whole rather than any particular program or project. These are not costs associated with the delivery of program services. Nonetheless, they are essential costs of maintaining and managing the organisation through which program services are delivered. Examples of such costs include IT, marketing, fundraising, human resources, strategy development, learning and development, measurement and evaluation, finance and accounting support, and bank fees and board meetings. Funders will often not distinguish between shared and indirect costs...

...Figure 1 shows that the full cost to deliver a program includes not only the direct costs, but a proportion of the shared and indirect costs of the organisation. These definitions apply equally to for-profits as they do to not-for-profits. The key difference is that in for-profits they are almost never used in isolation and are instead analysed in relation to the sales and profit it generates.

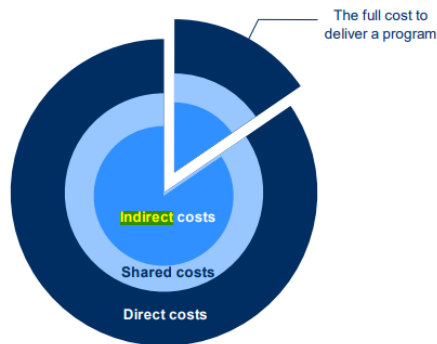


Figure 1: Full costs to fund a program

