Paying Nonprofits: Streamlining the New York State System

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Many state and local governments now rely on contracts with nonprofit organizations to deliver a broad range of public services. Nonprofits benefit from these contracts but can also experience costly delays in obtaining payment for services delivered. The article describes two laws adopted by New York State to curb these delays. One law deals with slow payment of vouchers. The other addresses the costly problem of delayed delivery of contracts for activities such as child care or services to the disabled where nonprofits cannot stop delivering services without harm to the recipients.

IMPROVING the quality of public services while restraining their cost ranks high among the contemporary concerns of domestic government. To achieve these objectives, many state and local governments have increasingly come to rely on contracts with nonprofit organizations—such as voluntary hospitals, child-care agencies, and community centers—to deliver a broad variety of public services. The arrangement is one with significant benefits for both contracting parties. Government gains access to the professional capacity, commitment, and community roots of the nonprofits, generally at lower cost than if it delivered the same services through its own staff, and the nonprofits gain critically needed financial support to enable them to address community service goals they share with government agencies.

The contracting arrangement is also one of significant fiscal importance to both parties. In New York State, for example, payments to nonprofits account for fully one-tenth of the annual

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budget. And for many of the state's nonprofits, payments from the state and local government account for well over half their total revenues.

As with any significant relationship, problems arise in governmental contracting with the nonprofit sector. This article describes how New York State dealt with two problems that seriously obstructed the flow of funds under contracts between governmental agencies and nonprofit organizations.

New York State's Contracting with Nonprofits

The state of New York relies heavily on nonprofit organizations

The state of New York relies heavily on nonprofit organizations for the delivery of a broad array of health, housing, and human services, as well as programs in fields such as the arts, other areas of culture, and recreation. Overall, direct state contracts with nonprofits have averaged over $800 million a year. In addition, substantial sums are involved in payments to nonprofits for services under programs such as Medicaid and foster care. Other services delivered by nonprofits are financed indirectly, through state aid payments to county governments and New York City. My overall estimates suggest that state budget appropriations allocated to nonprofits to pay for service delivery amount to nearly $5 billion a year, an amount equivalent to about 10 percent of the entire state budget.

The state of New York is by no means unique in its substantial reliance on contracts with nonprofits for service delivery. Other states in the Northeast, including Massachusetts, Connecticut, Rhode Island, and New Jersey, for example, also place a high degree of reliance on this form of service delivery, especially in the health and human services fields. States elsewhere in the nation utilize nonprofits to deliver services as well.

The fiscal significance of New York State contracts varies widely among the over 5,000 nonprofit organizations that hold service contracts with one or more state agencies. For many, however, state payments constitute a substantial fraction of their total revenue. For example, a recent survey of nonprofit organizations across the state indicated that federal, state, and local government payments combined accounted for 55 percent of total revenues for the typical respondent in 1986; the next most significant source of revenue was fees, which accounted for only 18 percent (Dawes and Saidel, 1988).

Two types of cash flow problems have arisen in New York to disturb the contractual relationship between nonprofits and the state agencies for whom they work: slow turnaround time on vouchers submitted for payment and delays in approving contracts. How the state of New York recognized and dealt with each of these problems is discussed in the remaining sections of this article.

Expediting Voucher Payments

Historically, the first of the two cash flow problems to which the state responded with remedial action was that involving vouchers for services being provided under a signed and approved contract. Both nonprofit and for-profit organizations often complained of the inordinate time it took to process the vouchers they submitted to state agencies for services rendered or goods delivered. The situation became exacerbated and the volume of complaints expanded for a time in 1982, when startup difficulties with the state's then newly installed accounting system resulted in a sharp rise in payment delays.

After considerable lobbying by business associations whose members were vendors to state agencies, a proposed solution was put forward by several state legislators, based on federal legislation adopted in 1982. This won bipartisan support from the Democratic-controlled Assembly and the Republican-controlled Senate. In 1983, both houses of the legislature adopted a bill mandating state agencies to pay every legitimate voucher promptly—or pay interest to the contractor on the amount of the voucher for the extra time it took to pay the invoice.

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The initial version of the bill was vetoed by Governor Mario M. Cuomo because, in his view, it failed to give state agencies adequate authority to delay questionable payments (State of New York, Executive Chamber, 1983). A compromise measure, developed by the governor's staff, the Office of the State Comptroller (OSC), and legislative leaders was enacted in 1984. The new law allowed state agencies forty-five calendar days to process each voucher. The time was divided between the contracting agency, which was given thirty-three days for its share of the work, and the Office of the State Comptroller, which was allotted up to twelve days. The agencies and OSC were required to pay interest to the vendor whenever they allowed a voucher to go past these target times without a valid reason—for example, that the goods in question had not been delivered, or were faulty, or that some other significant contract provision had been violated. The rate of interest to be paid was the same rate as that set in state law for delinquent corporate tax payments, generally about two points over prime. The source of funds for interest payments was the budget of whichever state agency was at fault for the delay.

Even the new compromise version appeared likely to impose significant interest costs on state agencies. An OSC analysis, based on a sample of vouchers processed during the first six months of fiscal 1984, projected that unless agency performance improved the likely result would be annual interest costs to the state of $11.5 million (Edward Henderson, deputy comptroller, letter to Henrik Dullea, director of state operations, Jan. 1984). In practice, however, the law's incentives proved highly effective in causing state agencies to improve their internal procedures and assign additional staff so as to expedite voucher processing. As a result, total interest payments over the first five years in which the law was in full effect averaged less than $1 million per year. Thus, the cost to the state was modest, especially in light of the benefit to private vendors and contractors.

Prompt Contracting Problem

As the Prompt Payment Law began to take effect, one might have expected contractor complaints to decline. Instead, complaints from nonprofit contractors rose significantly in 1987 and 1988. These complaints largely involved cash flow problems related to slow contract preparation and approval. What the nonprofits were saying was that, in many instances, state agencies were taking advantage of the contractor's willingness to continue providing services even after a contract had expired. In other instances, the nonprofits objected that after they initiated new programs on the promise of state agencies to deliver a contract, there were serious delays before the contract was approved. Virtually none of the contractors argued bad faith on the part of the state agencies with whom they dealt; contracts were apparently always eventually forthcoming. The nonprofits complained that while they were waiting for the state's bureaucratic delays to be overcome, their contracts could not be signed and therefore they could not submit vouchers. In the meantime, they had to cover the cost of service delivery from their own funds.

Virtually none of the contractors argued bad faith

State agencies tended to have different views about the reasons for delay in contract approval. For one thing, they cited the growing problem of late budgets. During the past five years, no state budget has been fully adopted and gone into effect by the April 1 date when the state's fiscal year begins. And the situation has grown worse each year. The 1992 budget was not adopted until mid June, nearly three months into the fiscal year. Another argument advanced by state agencies was that nonprofit contractors themselves were often the cause of delay by failing to submit adequate contract proposals or budgets and by their slow turnaround of essential documents.

Both viewpoints had merit. Nevertheless, the impacts of delay were clear.

The most severe problems triggered by contract approval delays affected nonprofits providing continuing services. Examples of such services include day-care programs for preschool children, recreation and food services for the elderly, and residential treatment centers for the developmentally disabled. Such activities require that staff and facilities be kept operating on a continuing basis from year to year. But virtually all state contracts were written for a single year at a time, reflecting the annual appropriations in the state budget. Delay, whether due to late adoption of the state budget or other problems, disrupted the payments that nonprofits counted on to meet their payrolls. Faced with the prospect of having to stop a continuing service program in midstream when an annual contract expired, with disrupting effects on clients and staff, virtually every nonprofit contractor chose to continue its programs. In doing so, they relied on the expressed intent of state agencies to process a new contract as soon as possible. In the meantime, however, no funds flowed. In the absence of a contract, vouchers could not be submitted, and thus the interest penalties of the Prompt Payment Law also did not apply.

While no precise data are available on the cost of state contract–related cash flow delays to nonprofits, it is the author's estimate that by 1989 these costs amounted to about $16 million per year. This estimate is based on the assumption that two-thirds of the annual $800 million worth of contracts was for continuing services, that renewal contracts were being delayed by an average of three months each, and that it cost the typical nonprofit 12 percent per year—either to borrow or in foregone earnings on working capital—to cover such costs. (Thus, 66.7% X $800 million X 0.25 year X 12% = $16 million.) Often, the only way these costs could be met was from the private charitable resources of the nonprofits. Some nonprofit leaders, at a meeting sponsored by the Fund for the City of New York, described the situation as one that could seriously harm their private fundraising efforts if it became known to givers that their donations were going to subsidize the state's cash position.

The volume of complaints from nonprofits about missing contracts increased

Attacking the Contracting Problem

The volume of complaints from nonprofits about missing contracts increased, either because state agency delays in processing contracts grew worse or because the state's recognized success in faster voucher handling raised expectations. Eventually, statewide affiliations of nonprofits—led by United Way—brought the matter to the attention of the governor's staff, the legislature, and the state comptroller.

Proof that the contract processing problem was severe came from several sources. First, nonprofit groups—ranging from large, well-financed agencies to small, newly created minority groups—stressed this as their principal problem at public hearings.. A second indicator of the extent of the state's contract delay problem came from a questionnaire distributed by United Way of New York State to all nonprofits that held state contracts. While only a tenth of the more than 5,000 contractors responded, it was clear from their responses that delays in contract renewal were both widespread and costly to nonprofit service providers. Many noted—

in quite graphic terms—that they were being forced either to use their own scarce resources to finance public service delivery or to borrow. The delays cited by the respondents were substantial: delays of at least three months were reported by numbers ranging from 29 percent of the 87 respondents with Office of Mental Health contracts to 52 percent of the 110 respondents with Department of Health contracts (United Way of New York State, 1989).

A third source of data was a study by OSC of contract processing by several state agencies. The study found that while speedier voucher processing had improved cash flow to nonprofits under contract with state agencies, the "precontract phase" was continuing to cause problems. Over half of the sample of contracts covered by the OSC study were not approved until at least three months after the date on which service delivery began and the nonprofit organization started to incur costs (Office of the State Comptroller, 1986).

State agencies were challenged to adopt these targets

In light of this evidence on the extent and severity of the contract problem, the comptroller wrote to the governor in 1987 and proposed a joint effort to address the problem. The governor responded by designating his Office of Management and Productivity (MAP) to take the lead in working with OSC staff and key agency personnel to define the contracting problem and to recommend remedial action. This task force began with a series of working meetings. At many of them, state contracting personnel were joined by representatives of statewide nonprofit affiliations.

Early task force efforts investigated many facets of the contract process. Prompt process was made on some facets, such as standardizing the "boilerplate" legal provisions in state contracts. Another task force initiative was to devise realistic target time schedules for processing both continuing and one-time contracts. State agencies were challenged to adopt these targets and to develop management information systems for tracking progress against them. The task force's first major breakthrough, however, came from a long-discussed idea: shifting from single-year to multiyear contracts for service programs where there was expected to be a continuing relationship between a state agency and a nonprofit provider. With support from the staff of the state comptroller and Division of the Budget, several major state agencies began to write multiyear contracts. (In reality, these are not true multiyear contracts but rather assurances of speedy and simplified renewal in subsequent years. Because of the state's annual appropriation process, the two to four years after the initial service commitment are always subject to an "executory" clause—meaning that the contract is nullified if the legislature does not appropriate funds in subsequent years.)

With the gradual spread of multiyear contracts and other changes to more programs and agencies, improvements in contracting were being made. But it was clear from the level of complaints still being registered by nonprofit contractors that the problem had not by any means been resolved. This became evident at three regional meetings held by the task force to inform nonprofits of the steps being taken and to allow them to raise their concerns directly with top staff from the principal contracting agencies. Representatives from over a thousand nonprofit providers attended these meetings.

Among the frustrations experienced by the members of the task force and their colleagues from the nonprofit sector was the variable treatment given to contracts by the Division of the Budget, whose examiners had approval authority over all state expenditures, including contracts. Some budget examiners approached their contract approval responsibility in a "wholesale" fashion, reviewing and approving entire service programs at a single time, then authorizing the contracting agency to forward its contracts for approval by the attorney general and comptroller without contract-by-contract scrutiny by the examiner. Other budget examiners adopted a "retail" style, insisting on seeing each of hundreds of individual service contracts. Whatever the examiner's style, all state agencies protested that during the several months in the year when the executive budget was being formulated and adopted, it took precedence and the flow of contract approvals slowed to a trickle. Budget responded by citing its responsibility for safeguarding public funds and the resulting need to preserve the discretion of its staff to examine all aspects of state spending. They and others also noted that many delays in contract processing occurred within the state agencies' own bureaucracy and on the part of the nonprofit applicants for contract funds. In addition, time was lost when complex policy issues arose, such as how to handle church-state relationships in education and construction programs.

Time was lost when complex policy issues arose

In a parallel effort to break through the maze of administrative obstacles slowing the task force's efforts to cut contract processing time, the state comptroller and several nonprofit leaders began work on ideas for legislation that would mandate reform of the contract system. In 1989, bills to this effect were drafted with joint sponsorship by many members of both houses of the legislature. As finally developed in a jointly agreed version, the bill contained the following key provisions:

Time targets (largely based on those already developed by the task force) were established, with separate schedules for the renewal of continuing service contracts and for new or one-time contracts.

Requirement of a "program plan" approach for Division of the Budget authorization of contracts in lieu of contract-by-contract approvals was instituted to help ensure that the overall time targets could be met.

The payment of interest by the responsible state agency to any nonprofit whose contract approval was delayed past the applicable time target and that continued to provide services was mandated. The interest penalty was based on the experience under the Prompt Payment Law, where the threat of being charged interest had caused state agencies to focus on how they could cut processing time.

Unlike the Prompt Payment Law, which applied to all vendors, the Prompt Contracting Bill was drafted to apply only to nonprofit organizations that contract with state agencies. The draft bill, with some changes such as the addition of an interest-free cash flow loan fund, was passed by both houses of the legislature in 1989. It was then formally submitted to the governor. However, during the ten-day period allowed for the governor's decision, the sponsor in the Assembly (where the bill originated) was persuaded by the executive branch to exercise his right to withdraw the bill. He did so in light of the governor's stated intention to issue an executive order directing state agencies to observe the time targets contained in the legislation and to report publicly on their progress in doing so.

Agencies must act to avoid late payments on nonprofit contracts

The governor then issued Executive Order no. 127 (*Not-For-Profit Contracting Process*) on July 21, 1989. The executive order

Declared as a matter of state policy that, because of the vital role played by the nonprofit agency network in delivering health, education, and human services for the state, agencies must act to avoid late payments on nonprofit contracts.

Established time targets for processing continuing and new or one-time contracts.

Directed state agencies to continue to work closely with the Office of Management and Productivity, the Office of State Comptroller, and nonprofit sector leaders to devise new and improved approaches to contracting. Toward this end, an advisory board was established, thus formalizing the role of the task force.

The executive order also instructed all state agencies to report to the governor's office twice a year on their progress in meeting the designated time targets for contract processing. The first such progress report, measuring what had happened during the first six months of 1990, revealed that only one in five of the contracts scheduled for approval during the six-month period had actually been approved by its scheduled starting date.

Once again, at the next session of the legislature, what had by now become known as the Prompt Contracting Law was introduced. The measure (Senate Bill 5371-B) was adopted by both houses without a dissenting vote. Once again, it was formally submitted to the governor. This time, it was not withdrawn and he vetoed it on October 10, 1990. The veto message argued that the bill was flawed by such things as a rigid time table and potentially costly interest payments. The governor also noted in his message to the Senate on October 10, 1990, that his executive order on contract processing had not yet been given a fair test, especially in light of the late passage of the state budget.

The governor proposed his own version of Prompt Contracting legislation—Governor's Program Bill 101—which was submitted to the legislature in April 1991. The executive proposal contained a limited approach to assessing interest penalties on state agencies when they were responsible for late contract approvals and retained considerable discretion for the Division of the Budget to waive time deadlines.

By this point, however, legislative opinion had clearly begun to stiffen in favor of a more mandatory approach with heavy reliance on interest penalties and very little discretion for the executive branch. In the spring of 1991, as the legislature once again considered its own version of Prompt Contracting legislation, there were few if any discussions between legislators and the governor's office in an effort to develop a compromise version. In fact, the legislature's version was strengthened in ways that made it even less acceptable to the executive: first, all contract approvals were required to be grouped in the form of program plans (as distinct from individual contracts), and second, the Division of the Budget was mandated to approve each such plan by issuing a certificate authorizing expenditure within forty-five days of its receipt—and was given no discretion to amend or reject the plans. The legislature then adopted the Prompt Contracting Law as an amendment to the state budget's revenue appropriation measure, an act not subject to the governor's item veto because it originated in the legislature rather than as part of the executive budget.

Legislative opinion had clearly begun to stiffen

As adopted, the Prompt Contracting Law contains a number of innovative provisions:

Time targets are set for renewal of continuing contracts. State agencies are also given broad authority to extend existing contracts so as to provide cash advances where they are unable for any reason to get a renewed contract in place by the expiration date. If the agencies do not do so, interest on any delayed funds must be paid to the nonprofit by the state agency awarding the contract, whether that agency or some other unit of government was responsible for part or all of the delay. Only if the state agency declares the nonprofit to be uncooperative and nonresponsive can it avoid responsibility for interest charges in the event of delay.

Time targets are also set for new or one-time contracts. Generally, these targets call for completing contracts within 120 days of the appropriation, or 150 days if a formal competitive process is to be used to select contractors.

With final passage of the Prompt Contracting Law, a new stage opened up in New York State's efforts to solve the cash flow problems afflicting its nonprofit contractors. As of the spring of 1992 implementation of the law was still in its early stages. Among the earliest steps taken were the issuance of implementing regulations by the Division of the Budget and OSC.

Controversy over the law continues. In part, this is because the early implementation stages of the Prompt Contracting Law have taken place during a period of severe fiscal stress in New York. For one thing, the fiscal 1992 budget was adopted very late—after almost a quarter of the year had elapsed. Then, due to midyear budget shortfalls in fiscal 1992, the Division of the Budget froze all contract awards, suspending for a time the contract processing targets and interest penalties under the law. This meant that during the initial year of the law's operations, special steps had to be taken to prevent massive interest penalties from being imposed on state agencies. This added to uncertainties about the working of the new law resulting from the fact that the conflicts that arose between the executive branch and the legislature during its passage were never worked out, as is normally the case with new legislation. Thus, as adoption of the fiscal 1993 budget approached, controversy continued as to how to deal with the interest penalty provisions. Fortunately, the fiscal 1993 budget was adopted on time. This should make it possible for the law to go into effect under less stringent conditions.

Steps had to be taken to prevent massive interest penalties

Two things seem reasonably clear, even at this early point in the law's life. First, the legislature has very firmly established as state policy a high standard of administrative performance and equitable treatment of the nonprofit organizations that participate in New York's public-private partnership. Second, state agencies are taking very seriously the time targets for contract award, and especially the accompanying threat of interest penalties that will be exacted from their operating budgets. These represent major changes in the contracting environment for the nonprofit sector.

Potential Relevance to Other States

New York State's experience under the two laws discussed in this article seems likely to be relevant to other states as well as to local governments, given the growing reliance of the public sector on the role of nonprofit providers in areas such as human services.

Many other states, as well as the federal government, have already acted to ensure prompt processing of vouchers submitted by their contractors. This type of provision appears to have become generally accepted as a necessary step by government to achieve continued access to the most competent vendors of service, whether in the for-profit or the nonprofit field.

Based on conversations the author has had with government officials and nonprofit contractors from other states, the scale of New York's problem in slow processing of contracts may be significantly larger than in other states. However, the problem is by no means unknown elsewhere. Thus, nonprofit managers and boards of directors in other states may want to monitor New York's experience to see if comparable legislation may be needed to help them control—or avoid—the type of painful cash flow problems experienced by nonprofits in New York.

As far as New York itself is concerned, only time will tell whether the Prompt Payment and Prompt Contracting laws can achieve their objectives of more equitable and efficient governmental contracting practices.

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