Strategic Positioning and the Financing of Nonprofit Organizations: Is Efficiency Rewarded in the Contributions Marketplace?

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Abstract

This article addresses the question of whether operational efficiency is recognized and rewarded by the private funders that support nonprofit organizations in fields ranging from education to social service to arts and beyond. Looking at the administrative efficiency and fundraising results of a large sample of nonprofit organizations over an 11 year period, we find that nonprofits that position themselves as cost efficient – reporting low administrative to total expense ratios – fared no better over time than less efficient appearing organizations in the market for individuals, foundations, and corporate contributions. From this analysis, we suggest that economizing may not always be the best strategy in the nonprofit sector.

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Today, the nonprofit sector plays an increasingly important role in the provision of vital services in fields such as health, social services, and education. The size of the nonprofit sector has increased rapidly over the past 50 years from a little more than 12,000 organizations in 1940 to over 1.5 million organizations today, including 501(c)(3) public-serving nonprofits that are organized for religious, educational, charitable, and scientific purposes, as well as a host of member-serving nonprofits, such as business made it harder for many of these organizations to achieve long term financial stability. Charitable nonprofits raise funds through two principal means (Hansmann 1981). The first is through the charging of fees for the delivery of services or the creation of commercial ventures designed to generate a stream of earned income. Over the past two decades, these “commercial” forms of revenue have become a critical source of operating funds, one that has given nonprofits the ability to launch and sustain initiatives by having clients and consumers pay for part or all of the cost of delivering services (Weisbrod 1999). The second way nonprofits support their operation is through donations and grants. By emphasizing the public-serving nature of their work, many “donative” nonprofit service providers are able to elicit a stream of contributions that provides critical working capital for their operations (Gronbjerg 1993). For organizations that work with disadvantaged populations or that seek to provide a service for free or at a subsidized price, contributed income is often a critical ingredient in their financial strategy. Today, there are few entirely donative or entirely commercial nonprofit organizations. In the face of a tight market for contributions, many nonprofits have attempted to alter and diversify their funding bases from a predominant reliance on interested in the question of whether strategic positioning around efficiency, defined as the reporting of a below average administrative to total expense ratio, increases the contributed income that a nonprofit organization is able to raise over time. Beyond a need to build legitimacy and donor confidence that may underlie the "new bottom-line" movement in the nonprofit sector, there has been much talk about the growing sophistication of philanthropy, evidenced in the expectation of donors that their contributions be well spent. This research asks how much reality lies behind this new rhetoric and whether the funders of nonprofit organizations have indeed begun to take more seriously the efficiency of the organizations they support. Thus, while the efficient management of nonprofit organizations may serve a range of purposes, we are interested here in whether it has an impact on an organization's ability to attract public support as measured by contributed income.

The paper moves toward an answer in four steps. First, we set the stage by considering the background issues and previous research related to this question. Second, we define the research hypotheses that guided our work. Third, we present our model and analyze the findings. Finally, we conclude with some broader reflections on the question of nonprofit management and accountability.

almost always without taking into consideration the activity of the recipient organizations.

In this article, we start with a different set of concerns and assumptions about contributions to the nonprofit sector. Rather than begin with the question of what determines the amount of contributions made by supporters of nonprofit organizations, we draw on a management manuals designed to give nonprofit leaders tools to improve their operations (Light 2000).[2]

improve their organizations and manage more effectively and efficiently (Antos and Brimson 1994; Dropkin and LaTouche 1998; Drucker 1992; Eadies and Schrader 1997; Firstenberg 1996; Pynes and Schrader 1997; Wolf 1990). Many of these titles attempt to bring business concepts such as reengineering, quality management, and benchmarking to bear on the nonprofit sector, usually with the intent of raising the level of organizational and program performance. A common theme that emerges from these texts is that the absence of a traditional bottom line in the nonprofit sector – far from freeing nonprofits to blindly pursue their missions – means that these organizations must manage especially well and develop a special kind of operational discipline. Though rarely expressed directly, these books suggest that a management lag between nonprofit and business sectors can be closed with a direct transfer of managerial technology.

The push toward efficiency and performance has been fueled by the rapid professionalization of large parts of the nonprofit sector over the past three decades (Frumkin 1998). Many professional staff want to bring a new rigor to their work and develop standards to measure their performance, both as the basis for their own advancement within the field and in the effort to build a growing body of expert knowledge. For professionals, the ideas of reengineering processes, introducing quality management systems, and benchmarking are appealing because these techniques hold out the promise of supporting and justifying the move from volunteer labor to well compensated professional staffing. With their desire to avoid charges of amateurism that have plagued this sector in the past, the growing ranks of nonprofit professionals have turned out to be the perfect audience for claims that cost effectiveness represents the new frontier of nonprofit management.

As professionalism has set in, competition for contributed income has intensified, particularly among start-up organizations. Many nonprofit managers confront the fact that there are often several nonprofit organizations with similar missions operating close by one another with little coordination. In some fields, the competition has gotten quite heated. In the case of international relief, efforts to win support have led to efforts at

reporting forms, but small individual contributors rarely inquire in any depth into an organization's finances. In addition, there is considerable concern about the accuracy of the information detailed on the federal reporting forms because of the vagaries of some of the categories and because audits of nonprofit organizations have become an increasing rarity. The IRS has only a small enforcement office that has struggled to keep up with the explosive growth of the sector (Gaul and Borowski 1993, Greene and Williams 1995). Still, the information contained on the reporting forms can help us understand how many nonprofit organizations present themselves to the public. This public disclosure of information represents an organization's most visible statement of its financial condition and managerial priorities.

the underlying assumptions of the new literature on nonprofit management and the push towards greater attention to the bottom line within nonprofit organizations.

> **H1: Nonprofit organizations that have low administrative to total expense ratios and that appear efficiently managed will have more success raising contributed income than organizations that have higher administrative expense ratios.**

The second hypothesis we test rests on the assumptions held by some practitioners that competition for contributions does not take place in a well-functioning market where information about nonprofit performance is scrutinized and where efficiency is rewarded. Instead, H2 argues that the best predictor of an organization's ability to solicit contributions is the amount of money that the organization spends selling itself and its mission to donors in every way imaginable, from face-to-face solicitation of major gifts

III. Data & Methodology

The data for this analysis is drawn from information provided to the Internal Revenue Service (IRS) by nonprofit organizations that are required to file an IRS Form 990 information return (Return of Organization Exempt From Income Tax). The data set covers the period 1985-1995. Although nonprofit organizations are generally exempt from paying income tax, they must nonetheless file an annual return with the IRS reporting detailed financial and other activity for the year. Three important categories of nonprofit organizations are not required to file IRS Form 990 information returns: religious organizations, private foundations, and nonprofit organizations with gross receipts less than $25,000.

In order to qualify for tax-exempt status under section 501(c)(3) of the Internal Revenue Code, the primary mission of the organization must be charitable, religious, scientific, literary, educational, or promote public safety, prevent cruelty to children or animals, or foster amateur sports competition. Operating under this broad umbrella of exempt purposes that has been amended and extended over the years, nonprofit organizations not only enjoy the benefits of income tax exemption but also donors are entitled to deduct charitable contributions from their income tax returns. Yet each nonprofit organization must serve the public good as opposed to private gain in order to maintain exempt status. Thus, exempt organizations may not distribute their net earnings (i.e., profits) to shareholders or other individuals but rather must use them to further the only those nonprofit organizations appearing in each panel year. This balanced panel consists of 2,359 nonprofit organizations, yielding a total of 25,949 observations. This panel constitutes a stratified random sample of the universe of nonprofit organizations that are required to file an IRS Form 990 information return. The IRS adopts a stratified sampling approach in which the sample is classified into five strata based upon total asset size with each stratum being sampled at a different rate (IRS 1991; 1993).

B. Dependent Variable

The dependent variable in our model is private donations in a given tax year. Some researchers have cautioned, however, that a potential problem may exist because of of the NTEE: arts, education, health, human service[4], public benefit[5] and other[6]. By measuring efficiency within subsectors and seeing if it is a good predictor of

IV. RESULTS & ANALYSIS

We began this investigation with the question of whether efficiency – reflected in below average administrative to program expenses – helped nonprofit organizations in the marketplace for contributions. We looked at the influence of efficiency on contributions within the major fields of activity that nonprofits populate. This means we sorted organizations by their areas of activity (i.e., arts, health, education, human service, public benefit, and other) and then asked whether being more efficient than the competition in one's own field yielded greater levels of contributions. Our belief is that few donors make their charitable giving decisions by comparing, for example, an arts positioning did not appear to be a factor in determining the level of contributions received, these are intriguing and substantively significant findings. They indicate that nonprofit organizations that spend more marketing themselves to the donating public do better at raising contributed income. No matter the field of activity, positioning around mission influenced the flow of contributions. These results strongly support the second of the two hypotheses we defined earlier.[8]

With R-Squares ranging from .13 to .44 our models did only moderately well in predicting contributions. Still, in order to assure ourselves that concerns over errors in the completion of the 990 Forms might have skewed our results, we did a sensitivity analysis. On the assumption that nonprofit managers may not fully understand the various reporting categories of contributions, we estimated another version of our model using total contributions as the dependent variable. A general pattern emerged with the coefficient estimates similar in both sign and magnitude, which suggests that any "problematic" Form 990 filers do not pose a threat to our analysis.[9]

We believe that the results of the analysis are important for two reasons. First, they cast doubt upon the wisdom, at least in part, of the growing tidal wave of advice that nonprofit organizations are receiving from the new literature on nonprofit management. While tighter operations, leaner staffing, and other tools designed to lower administrative costs might well increase margins on earn45.33 TD-0tr.3(r)eanale earall inc esewit isncohe nonprofonssuc9(hteponspptte)-6.ardo nod te ie rinsron influskcl contriborons.theey

nonprofo c(W)-6.a(e)3.re r1yiour ria(W)-6.sige u2(eer)-10(W)-6.si--1ryayieW still be driven more by donor identification with organizations than by economizing and positioning based on low administrative expense ratios.

In light of these conclusions, arguments about bringing a new bottom line to the nonprofit sector will need to be based on something other than a claim that donors recognize and reward efficiency by increasing contributions to lean organizations. It may be that efficiency is critical to ensuring that the commercial side of nonprofit operations maximizes earned income. Who after all could quarrel with the logic of a claim that organizations with lower overhead and administrative costs are in a better position to increase the revenue derived from fees for service and ventures? However, when it comes to attracting the critical contributed income on which many nonprofits rely to fuel their charitable activities, particularly services that are offered to disadvantaged populations, operational efficiency does not appear to be a critical consideration in the eyes of contributors.

V. DISCUSSION

Some will surely object that efficiency has been shortchanged in this analysis. After all, proper marketing, positioning, and fundraising strategy only assure that an organization has made its case to the public, not that an organization has a record of efficient operation that will ensure its survival in the competitive environment of the increasingly commercial nonprofit sector. More than anyone else, Willliamson (1994) has voiced a clear objection to the emphasis on strategy in the broader management literature. Williamson has forcefully argued that excessive concern over strategy and positioning obscures the fact that efficiency remains a more critical factor to organizational success and that economizing is much more fundamental than strategizing. Williamson's point

decisions, it is reasonable to ask whether there is an adequate supply of information. The answer is unclear at present.[10] In fact, only within the past year has the IRS moved to put in place new disclosure requirements for nonprofit organizations. Nonprofits must now mail their Form 990 to any interested party or post it on the Internet. This marks a major change from the previous disclosure law, which only required that the forms be shown upon request in a charity’s office. Few contributors ever made pilgrimages to see the forms and the supply of information on the management of public charities was therefore largely determined by what organizations chose to disclose in their annual reports.

Despite this recent reform, there is reason to believe that improvement in the quantity and quality of information supplied to donors will not be instantaneous. A study of 990 returns from exempt organizations in twelve states, begun after the new disclosure regulations took effect in June 1999, revealed that just 37% immediately fulfilled 990 requests, and 31% responded in ways coded as obfuscation—they referred survey takers to another office, or required them to leave voicemail messages that were not returned (Stokeld 1999). The study organizer suggested that many organizations appeared either to be following a long-established process, or to have no process at all, for responding to information requests. Whether 990s will become substantially more accessible in the future depends on several unknowns, including how quickly organizations communicate rules changes through their networks, and how aggressively the IRS is perceived to be directly with nonprofit organizations, and building a credible enforcement staff capable of letting nonprofits know that disclosure is a critical responsibility.

There is at least one major development on the horizon that may help answer questions about the supply of information. A new nonprofit organization has been formed to disseminate financial information on nonprofits over the Internet. The project, known as Guidestar, is still in its early stages, but it promises to overcome at least part of the information problem. The Guidestar web site will allow any person to access the essential financial data for a large number of nonprofit organizations. Information about operating expenses, administrative overhead, and fund raising costs will all be available to potential contributors and volunteers. The goal of the project is to make research on nonprofits easier for the average donor by putting this data where it is easiest to access.

While Guidestar has promise, it will need to address a key obstacle: Major gaps in what one might call the generally accepted accounting principles for nonprofits make it hard to ensure the accuracy of reported information. This is especially problematic given that Guidestar has also set up links to on-line giving programs. This allows contributors to look up information and then make pledges on-line very quickly. The obvious temptation for many charities will be to put their best foot forward and to engage in a kind of strategic “gaming” aimed at making themselves look as efficient as possible. With contributors’ dollars hanging in the balance, Guidestar may well end up fueling a race to the bottom as charities use creative accounting techniques to control their image. None of these technical problems is insurmountable with a few modest reforms, including separating more clearly the reporting and fund-raising functions of the service and developing a workable auditing system. To date, however, it remains unclear how aggressively Guidestar will counter these pressures, while ensuring the broadest possible participation among nonprofits.

The problems associated with nonprofit accounting are significant enough to lead Herzlinger to argue that the only real solution to the accountability problem in the nonprofit sector may lie in the establishment of an SEC-type organization that could ensure openness and disclosure as way of regulating through information (Herzlinger 1996). The principal role of a “nonprofit SEC” would be to be to bring uniform accounting techniques to public charities, disseminate information on the financial condition of organizations, and create channels through which donors, volunteers, clients, and community members could access and use this information. Of course, this would be a far more complex proposition in the nonprofit sector, in which lines of ownership are overlapping and ill-defined, than in the business sector, in which one group of owners, namely shareholders, have clear interests in accurate information. For information to have a chance to work as regulation and for Herzlinger’s provocative idea of a “nonprofit SEC” to have an opportunity to succeed, a major transformation is needed not just in the kind of information that is made available, but in the outlook of the many stakeholders of nonprofit organizations, including donors, clients and the general public.

We believe that ambivalence about some of the recent developments bearing on nonprofit information may be wise. On the one hand, the creation of ever more information about the management and finances of nonprofit organizations only bodes well for increased transparency within the sector and for broader accountability. On the other hand, it may not be entirely problematic that decisions about contributions remain for the time being – as they have long appeared to be – largely driven by legitimacy and positioning. After all, one of the best reasons to give is that a charity has communicated a clear and compelling mission with which donors can identify. Far from being an obstacle to be overcome at any cost, we think the findings reported here could be interpreted as pointing in the other direction. They remind us that contributors are still listening to fundraising pleas and that social cause, organizational mission, and personal commitment may all still matter in a sector not yet fully oriented toward efficiency.

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Table 1

Descriptive Statistics and Pooled Correlation Matrix for All Variables

Variable	Mean	S.D.	1	2	3	4	5	6

Notes

[1] Over the past decade a number of major financial scandals have rocked the nonprofit world, including the conviction and imprisonment of the president of the United Way of American for embezzlement, the jailing of the head of Foundation for New Era Philanthropy for perpetrating an enormous investment fraud that turned out to a massive ponzi scheme designed to separate donors and institutions from their money, and prosecution of leaders of the Espiscopa and Baptist churches for outright theft. If crimes were not enough, ethical lapses have also hurt the credibility o the sector and some its largest institutions. The ouster of the head of the National Association for the Advancement of Colored People over the improper transfer of funds to the president's

international and foreign affairs, religious, mutual benefit and membership, and unknown or unclassified.

[7] The presence of autocorrelation was ascertained using the Durbin-Watson statistic.

[8] Three other variables had sporadic effect on contributions: program expenses in education, total revenue in human service, and government grants and contracts in health and human service.

[9] Although the results of these regressions were not reported, they are available upon request from the authors.

[10] In testing the possibility of an information lag affecting contributions, we found little evidence in the data to support the claim that information about the past efficiency of an organization (going back several years) had any impact upon its present contributions.