Title: Outcome-Oriented Philanthropy and the Problem of Institutional Design

Authors: George E. Mitchell, Baruch College

Thad D. Calabrese, New York University

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Abstract: In line with recent calls to reexamine the fundamental precepts and conventional wisdoms of nonprofit studies, this article critically analyzes the institutional form of the US public charity and the 'standard theory' that describes it. This analysis demonstrates that the implicit objective function of the public charity is the maximization of resource provider satisfaction. Donors essentially purchase licenses to feel good from nonprofits in an 'iron circle' of virtually riskless mutual benefit transactions orthogonal to beneficiary welfare, and no reliable price or exit mechanisms exist to promote allocative efficiency consistent with outcome-oriented philanthropy. Further analysis attributes this scenario to the significance of strategic ignorance and information costs. Although reform is extremely unlikely, policy implications suggest specific means of developing an information ecosystem significantly more conducive to outcome-oriented philanthropy and the solving of the societal problems delegated to the nonprofit sector.

Keywords: Outcome-oriented philanthropy, institutional design, nonprofit theory, strategic ignorance, information costs

Outcome-Oriented Philanthropy and the Problem of Institutional Design

The dominant institutional form for philanthropic activity in the United States is the 501(c)3 public charity.[1] However, recent decades have seen innovations in institutional forms and instruments, particularly as more recent generations of philanthropists and 'social entrepreneurs' have increasingly adopted a focus on outcomes and cost-effectiveness (Brest, 2012) historically underserved by the traditional nonprofit ecosystem (Schmidt, 2014). The sector has seen increased experimentation through the use of philanthropic LLCs, B-corps, LC3s, impact investing, social enterprises, and hybrid organizations that combine elements of businesses, foundations, and public charities, presumably as means addressing perceived weaknesses in the conventional form of the public charity. Although the aggregate number of these alternative forms remains modest relative to the vast number of public charities, the experimentation itself strongly suggests that many philanthropists and social entrepreneurs regard the public charity as inadequate for their purposes.[2]

In light of recent calls to reexamine conventional wisdoms in the field of nonprofit studies (Mitchell, 2014, 2017b, 2018; Mitchell & Calabrese, 2018), this article critically analyzes the institutional form of the modern public charity and reconsiders the 'standard theory' of the nonprofit largely developed in the 1970s and 1980s that describes it. Specifically, this analysis reveals that the implied objective function of the public charity, inclusive of its regulatory and cultural architectures, is the maximization of resource provider satisfaction. Analysis also demonstrates that this function is fundamentally incompatible with the maximization of program outcomes, which might reasonably be regarded as a desirable objective function for at least some public charities. This guarantees inefficiency in the production of aggregate outcomes when compared to an alternative institutional design scenario in which certain information costs incurred in measuring outcomes are defrayed and distributed throughout an outcome-oriented philanthropic ecosystem.

This article is organized as follows. The next section reviews the diverse purposes of nonprofits in the US context and considers their expressive and instrumental dimensions. This is followed by an analysis of the contemporary 501(c)3 public charity as a device for maximizing resource provider satisfaction under the conditions posited by the standard theory of the nonprofit. The discussion then identifies various problems with the standard theory, subsequently elaborating on the significance and types of information costs. Discussions about nonprofit accounting practices and policy implications precede the conclusion.

The purpose of nonprofits

Nonprofit theory is complicated by the extreme heterogeneity within the sector. Although theory generally focuses on the modal type of donative public charity, in reality the sector exhibits great diversity in organizational size, structure, purpose, and revenue portfolio, and is at best awkwardly defined by tax-exemption eligibility criteria and an illustrative list of acceptable tax-exempt purposes. Under section 501(c)3 of the United States Internal Revenue Code (IRC), such acceptable exempt purposes include "religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition…, or for the prevention of cruelty to children or animals." The US Internal Revenue Service (IRS), which administers the IRC, has issued additional guidance, stating that:

> The term *charitable* is used in its generally accepted legal sense and includes relief of the poor, the distressed, or the underprivileged; advancement of religion; advancement of education or science; erecting or maintaining public buildings, monuments, or works; lessening the burdens of government; lessening neighborhood tensions; eliminating prejudice and discrimination; defending human and civil rights secured by law; and combating community deterioration and juvenile delinquency (IRS, 2018).

Moreover, the National Taxonomy of Exempt Entities (NTEE) recognizes dozens of categories of nonprofit organization, including 'fee-for-service' reliant organizations in education and healthcare that consistently rank among the largest public charities in the country. Although certain categories of nonprofits are subject to different regulatory requirements, they all generally operate under the same basic legal framework described by IRC Section 501(c)3 and the standard theory of the nonprofit that is discussed below.

Others have observed that nonprofits variously instantiate both expressive and instrumental purposes or dimensions of philanthropy (Frumkin, 2002; C. W. Gordon & Babchuk, 1959; Mitchell, 2018). Expressive philanthropy may involve traditional almsgiving, conformity with social norms or the avoidance of social disapprobation, the claiming of membership, affiliation, or solidarity, or the realization of 'warm glow' benefits (Andreoni, 1990; Crumpler & Grossman, 2008; Null, 2011). By contrast, 'instrumental' or 'outcome-oriented' philanthropy involves the solving of social problems given finite resources. This is philanthropic activity in which "donors articulate and seek to achieve clearly defined goals; they and/or their grantees explore and then pursue evidence-based strategies for achieving those goals; and both parties monitor progress toward outcomes and assess success in achieving them in order to make appropriate course corrections" (Brest, 2015).

The current legal framework and institutional form of the public charity in the United States are heavily conditioned by federal tax policies dating to the late 19th century (Arnsberger, Ludlum, Riley, & Stanton, 2008), predominantly having emerged from expressive philanthropic traditions (Hall, 2010). Over time, notions of a charitable sector gradually expanded to include other activities loosely contributing to public welfare and "lessening the burdens of government" (IRS, 2018). Over the course of the twentieth century, the legal framework of the public charity evolved to accommodate this evolution, expanding the legal definition of nonprofit and deliberately encouraging philanthropy through tax expenditures (Arnsberger et al., 2008). In light of this historical evolution, the emergence of outcome-oriented philanthropy *per se* is a relatively recent development that the inherited US legal architecture for nonprofits was not specifically designed to support.

Given the basic distinction between expressive and instrumental philanthropic purposes and the possibility of their being distinct institutional forms optimized for each purpose, a nonprofit sector might theoretically be comprised of organizations designed and regulated in the service of one of two alternative objective functions. In the first type of sector, nonprofits could be designed to maximize resource provider satisfaction by catering to the expressive needs of philanthropists. This type of nonprofit sector exists to provide maximum risk-adjusted utility to the donor. In the second type of sector, nonprofits maximize beneficiary welfare.[3] Analysis reveals incompatibilities between these objective functions, suggesting difficulties for outcome-oriented philanthropy and broader implications for nonprofit theory and public policy.

Maximizing resource provider satisfaction

The institutional design features of the 501(c)3 public charity make it suitable for expressive philanthropy and the maximization of resource provider (donor) satisfaction. According to the 'standard theory' of the nonprofit, nonprofits exist because for-profits cannot be trusted to produce unobservable outcomes.[4] The information asymmetry attendant to the separation between resource providers and program beneficiaries enables opportunistic behavior in contravention of donor intent. Thus, resource providers will not contract with for-profits to produce unobservable outcomes. Instead, resource providers will transact with nonprofits, because the nonprofit's 'nondistribution constraint' prevents private inurement and screens out profit-seekers (Steinberg, 2006; Young, 2013), thereby imbuing nonprofits with 'trustworthiness' (Hansmann, 1980; Weisbrod, 1988; Young, 2013). The constraint "blunt(s) the incentives for nonprofit mangers to take advantage of informational superiorities, since any additional profit obtained by capitalizing on such superiorities could not increase the income of nonprofit managers and directors" (Weisbrod, 1988, p. 158). Resource providers thus "prefer nonprofits [to for-profits] because that is the only way to be sure that contributions advance the stated goals of the organization rather than just increasing the profits of entrepreneurs" (Krashinsky, 1986, p. 121).[5]

Nonprofits thus specialize in the production of unobservable outcomes due to their comparative advantage in trustworthiness (Weisbrod, 1988). Even if observing nonprofit outcomes or performance is technically possible in principle, in practice the costs exceed the benefits. If it were otherwise then the problem of 'contract failure' would not arise, resource providers would contract with for-profits, and nonprofits would not exist. Indeed, Weisbrod (1988, p. 53) notes that "certain activities are in the public or nonprofit sector largely *because of* the complexity of assessing them." Although for Weisbrod and Schlesinger (1986, p. 149) nonprofit outcomes have both observable (Type I) and unobservable (Type II) dimensions, "for such goods, it is more efficient not to reward performance at all than to reward only the Type I dimensions."

However, the nondistribution constraint also imposes a negative side effect. If nonprofit practitioners cannot retain net earnings for private benefit, then they have a reduced incentive to minimize costs in relation to outcomes. As such, "inefficiency is inherently embedded in nonprofit services" (Kim & Kim, 2016, p. 2942).[6] Performance cannot be measured or rewarded, which incentivizes shirking and decouples a nonprofit's financial performance from its mission performance. Moreover, given legal requirements and social norms pertaining to nonprofit salary suppression relative to other sectors,[7] nonprofit employees, being unable to increase their salaries, can improve their effective wages by reducing their work effort, and implicitly, forgoing opportunities to maximize program outcomes. In principle, a nonprofit could persist indefinitely simply by satisfying resource providers and without ever meaningfully improving beneficiary welfare (Moore, 2000). Additionally, reputation effects must be arbitrary with respect to program outcomes because according to the standard theory outcomes are unobservable.

However, the non-observation of outcomes improves risk-adjusted resource provider satisfaction by eliminating the 'specter of disappointment.' If outcomes are not observed, then donors' optimistic conjectures about beneficiary welfare cannot be falsified, which licenses 'wishful thinking' and 'warm glow.' Thus 'strategic ignorance' is rational and satisfaction-maximizing (Pritchett, 2002). Organizational trustworthiness lends plausibility to the assumption that charitable contributions necessarily lead to desirable outcomes, absent explicit and credible evidence to the contrary. Indeed, this interpretation has significant theoretical and empirical evidence on its side. 'Informed giving' appears to be exceedingly rare (Krasteva & Yildirim, 2013, 2016) and givers appear to be averse to paying for information that would allow them to make more informed decisions (Null, 2011). Moreover, experiments in behavioral economics reveal that donors will contribute to nonprofits even under the complete certainty that their contributions will have absolutely no impact (Crumpler & Grossman, 2008).

[Insert Figure 1 about here.]

In this scenario, nonprofits essentially sell licenses to 'feel good' to donors. In this sense there is no information asymmetry because the resource provider is the recipient of the license.[8] The quality of the license is proportional to the trustworthiness of the nonprofit and the imagination of the resource provider. Figure 1 illustrates the 'iron circle' of resource provider satisfaction in which donors and nonprofits enjoy mutual benefits irrespective of beneficiary welfare. Donor utility can only be improved because non-observation eliminates the specter of disappointment. In Seibel's (1996) interpretation, observing outcomes would contravene donor intent by revealing problem unsolvability and revoking licensure. Donors pay to feel good, not bad—and that is the point.

Management implications

The principal tasks of the nonprofit manager in this scenario are (1) to protect resource providers from unwanted information while (2) maintaining organizational trustworthiness for the licensure of wishful thinking. The former can be achieved by not observing outcomes, providing plausible excuses for outcome non-observation, and by strategically manipulating information. Indeed, credible program evaluation is relatively uncommon in the sector (Mitchell & Berlan, 2016). Psychologically motivated donors predisposed to confirmation bias will interpret absent or tendentious information as confirmation that their wishful thinking is warranted.

The latter problem of trustworthiness is addressed through financial disclosure and surveillance. Nonprofit information intermediaries rigorously monitor nonprofits' financial records and provide ratings, rankings, and other designations that are observed by donors. Notably, the underlying financial reporting model that nonprofits must use centers on revealing whether donated contributions were diverted from direct program expenditures; the model is silent about whether a nonprofit's activities improve beneficiary welfare.

Generally, nonprofit trustworthiness is operationalized as the proportion of a nonprofit's total functional expenses classified as 'program spending' in a given fiscal year (Mitchell, 2018; Mitchell & Calabrese, 2018). The program expense ratio (or conversely, the overhead ratio) is commonly used in such evaluations.[9] Other commonly surveilled indicators of trustworthiness include (inversely) executive compensation, the cost to raise one dollar, and reserve and debt ratios. The accountability architecture in which the 501(c)3 public charity is embedded construes financial costs other than immediate program spending as theoretically available for opportunistic misappropriation, which signals untrustworthiness.[10] None of this systemic surveillance credibly conveys or evaluates outcome information.[11]

The production of program outcomes is at best orthogonal to trustworthiness. If managerial imperatives conflict, for example, nonprofit managers face incentives to sacrifice program outcomes to maintain the appearance of trustworthiness because the latter is observed but the former is not (Mitchell, 2018). Additionally, nonprofits risk disappointing donors if any revealed outcome information falls short of donor expectations. Donors may also interpret the achievement of outcomes as indicative of insufficient need for further funding (Charles & Kim, 2016). Nonprofit managers can mitigate a variety of significant risks by avoiding gathering data.

Moreover, the current accountability architecture contributes to the very information scarcity upon which it is theoretically predicated. Nonprofits are incentivized to maximize program spending defined as "the mission-related activities of the organization that result in goods or services being distributed to clients, customers, or members" (Flood, 2018, p. 1323). As with financial reporting in general, this definition excludes program evaluation, which is construed as "not part of the direct conduct or direct supervision of the grant" (FASB, 2016, p. 161). In other words, the financial costs of producing information about outcomes is recorded as a 'management and general' expense rather than a 'program' expense. Thus, under the current accountably architecture, nonprofits are penalized for producing outcome information (through the mechanism of overhead surveillance).

Societal implications

The non-observation of outcomes removes the specter of disappointment and thereby improves risk-adjusted donor satisfaction, but it also means that the philanthropic 'marketplace' cannot possibly have the information necessary for allocative efficiency because unobserved outcomes cannot be priced (Mitchell, 2014).[12] That is, there must exist superior allocations of resources that would improve the aggregate outcomes of the nonprofit sector holding total available resources constant. However, these allocations are undiscoverable because outcomes are not observed.

The nonprofit sector in this scenario is essentially a marketplace for licensures. The price of a licensure depends upon the donor's expected utility, which is itself a function of perceived licensure quality. Expected donor utility depends negatively upon the probability of observing disappointing information and increases with licensure quality with diminishing returns. Licensure quality may be influenced by such factors as the perceived reputation of an organization, signals of its trustworthiness such as may be indicated by watchdog ratings, seals of approval, and financial benchmarks, the persuasiveness of its emotional appeals and communications materials, and its general ability to strategically facilitate motivated reasoning (exploit confirmation bias). Licensure pricing cannot depend on outcomes because outcomes are not observed. In the extreme, the result is a nonprofit sector that maximizes donor satisfaction independently of beneficiary welfare.

Some problems with the standard theory

The standard theory of the nonprofit assumes that outcomes are either unobservable in principle or are too costly to observe relative to the benefits. In the both cases the proposition of outcome unobservability raises considerable difficulties, particularly for outcome-oriented philanthropy.

First, an axiomatic interpretation of outcome unobservability would require that the statement 'nonprofits make no observable difference in the world' be true. However, such a statement would appear to be normatively unacceptable and clearly contrary the positions of most philanthropists and nonprofit practitioners.

Second, such an axiom represents a rather strong metaphysical assertion with no inherent justification or seemingly acceptable ontological or epistemological interpretation. For example, are ‘unobservable outcomes’ to be regarded as ‘real?’ If so, what is the nature of their existence? What would be the difference between an unobservable outcome and no outcome at all? Academic research has accommodated this problem by construing organizational effectiveness not as an objective condition, but rather as a subjective, reputational construct (Mitchell, 2015; Mitchell & Stroup, 2016; Willems, Jegers, & Faulk, 2015) that is interpreted differently by different stakeholder groups (Herman & Renz, 1997, 1999, 2008) and therefore cannot be “a real property” of organizations (Herman & Renz, 1997, p. 188). Alternatively, rather than this validating a specific ontological proposition, it may instead simply be an artifact of general data unavailability.

Third, the standard theory essentially defines nonprofits as those entities that specialize in the production of unobservable, non-contractible outcomes. However, nonprofit contracting is commonplace, and many nonprofits do monitor and evaluate outcomes for at least some of their programs, whether for learning or compliance purposes. Contract failure theory can provide only a very incomplete explanation for the existence of nonprofits.

Fourth, in what is perhaps the most forgiving interpretation, outcomes are not to be observed because any benefits of observation are overwhelmed by ‘distortion costs.’ However, there does not appear to be any definite reason for this other than the tautology that the outcomes that fall to nonprofits are by definition of the unobservable type (or else contracts would not fail and nonprofits would not be needed). The standard theory does not specify how to assess the magnitude of distortion costs to determine whether they are worth incurring. Moreover, not observing outcomes also has costs, such as in terms of reduced performance and forgone beneficiary welfare.

In sum, it appears to be equally, if not more plausible that outcome non-observation is a condition for maximizing risk-adjusted donor satisfaction in a scenario in which donors are paying to feel good, not bad, and outcome observation would raise the specter of disappointment. Organizational trustworthiness remains essential because it helps to warrant wishful thinking. Nonprofits exist not because for-profits cannot be trusted to produce unobservable outcomes, but because certain consumers derive private benefits from nonprofit licensures. The nondistribution constraint imbues nonprofits with trustworthiness, while strategic ignorance guarantees that donors will not be disappointed. The non-observation of outcomes is an imposed design feature for the maximization of donor satisfaction, not necessarily a logical corollary of their being such things as ‘unobservable outcomes.’

Maximizing program outcomes: The problem of information costs

Outcome-oriented philanthropy involves strategic giving for the explicit purposes of achieving and maximizing program outcomes (Brest, 2012). Theoretically, outcome-oriented philanthropists seek to maximize outcomes per dollar, and thus require information about outcomes and their unit costs. Because outcome-oriented philanthropists are outcome-maximizing, they will always prefer resource allocations that correspond with higher levels of aggregate outcomes, given their preferences and mission valence.[13] Their philanthropic activity is ‘instrumental,’ more than ‘expressive’ and represents a goal-directed, evidence-based approach to problem-solving.

The principal challenges for outcome oriented philanthropy appear to be the mitigation and defrayal of information costs. Weisbrod and Schlesinger (1986) proposed that information costs are generally not worth defraying because the distortion effects of poor measurement will outweigh the benefits. However, this reasoning relies on the assumption that nonprofit outcomes are invariably unobservable or have significant unobservable components regarding which measurement must necessarily be poor; this entails a spectrum of seemingly unacceptable corollaries as has already been described. A notable alternative to outcome non-observation that has received less attention in the theoretical literature would be to seek improvements in measurement and evaluation quality so that it would not be poor.

Distortion costs are distinct from the direct financial costs of measurement and evaluation. In addition to distortion costs, outcome-oriented philanthropy requires that nonprofits incur a variety of additional ‘supply-side’ information costs. Evaluation costs include not only direct financial costs but also costs in terms of time, technical expertise, and the administrative infrastructure that makes evaluation possible. Nonprofits may have great difficulty funding evaluation costs and related investments because resource providers tend to interpret such expenditures as diversions of resources away from current mission programs. Although outcome production should increase positively with evaluation costs through intertemporal learning, donors in the current nonprofit environment typically cannot observe the benefits of superior outcomes but are likely to observe the attendant increased administrative costs that are likely to reduce perceived trustworthiness.

Nonprofits that do measure and evaluate outcomes must also have a means of usefully disclosing that information to resource providers and to the public generally. Disclosure costs can be significant for nonprofits, as they may require organizations to create and maintain systems not only for outcome accounting but also for reporting that information in a manner that external stakeholders can understand. Many nonprofits already produce annual reports, but these are unstandardized and unaudited. Outcome-oriented philanthropists are not assured that any outcome information contained within the reports is accurate or if, for instance, unfavorable information has been manipulated, misreported, or strategically omitted. Although nonprofits respecting the nondistribution constraint may be trusted to not embezzle, merely not embezzling is not identical to spending money on programs that achieve the intended outcomes. While the nondistribution constraint may help to prevent private inurement and ‘excessive’ benefit, it does little to ensure that non-opportunistic expenditures are spent efficaciously to produce meaningful outcomes. The sorting function of the nondistribution constraint may tend to disproportionately attract people who are genuinely committed to the organizational mission, but it does not guarantee their competence.

Finally, nonprofits must also incur auditing costs to assure the credibility of nonprofit outcome disclosures. Currently, outcomes are not part of any formal accounting regime. To summarize, nonprofits in an outcome-oriented philanthropic marketplace must mitigate or defray at least four categories of supply-side information costs: (1) distortion costs, (2) evaluation costs, (3) disclosure costs, and (4) auditing costs. These costs are internal to the nonprofit, although obviously for most nonprofits the financial costs must ultimately be supported by external resource providers.

Outcome-oriented philanthropists, on the other hand, confront a variety of 'demand-side' information costs. The transaction cost literature identifies at least three relevant types of such costs (Allen, 1998; Coase, 1937; North, 1987). These include the costs of (1) search and discovery, (2) bargaining and decision making, and (3) surveillance and enforcement.

Search and discovery costs include a philanthropist's costs to identify relevant nonprofits and to obtain information about their outcomes and corresponding unit costs. There is currently no sector-wide infrastructure to facilitate this. An efficient outcome-oriented philanthropic marketplace requires "high-quality information [that] will lead donors to allocate funds more strategically to organizations doing the best work" (O'Flanagan, Harold, & Brest, 2008, p. I). Such a marketplace would also necessitate a broader 'philanthropy ecosystem' capable of generating, managing, reporting, and evaluating information to facilitate outcome-maximizing transactions (Schmidt, 2014). Additionally, information intermediaries would likely be needed to facilitate bargaining and decision making (Ruff, 2013; Ruff & Olsen, 2016). Intermediaries can compile and evaluate information to support comparative analysis and provide relevant information to donors to inform strategic giving.

Finally, surveillance and enforcement is necessary to motivate accurate disclosure, discourage cheating and fraud, and establish and maintain reporting standards.[14] Currently, no such sector-wide oversight exists for the assurance of outcome information. Table 1 provides a summary of the six categories of information costs.

[Insert Table 1 about here.]

An efficient outcome-oriented philanthropic marketplace presumes that nonprofit outcomes are real and observable, and requires the defrayal of information costs to support allocatively efficient decision making. The standard theory of the nonprofit is predicated on the axiom that extreme information costs make nonprofit outcomes unobservable even in cases where such outcomes could be observable in principle. However, in the nearly 40 years since the standard theory was developed, a variety of profound technological innovations have radically reduced information costs (especially demand-side costs) and fundamentally transformed the informational environment. The advent of the internet, search engines, digital filing, fast, efficient, and inexpensive data processing and storage capabilities, and the emergence of online information intermediaries and data transparency platforms all offer outcome-oriented philanthropists relatively novel opportunities for the realization of an outcome-oriented philanthropic marketplace. However, the regulatory architecture and institutional form of the public charity have not yet adapted to take fuller advantage this new informational environment. Critical components of the philanthropic ecosystem remain absent, presumably for lack of a concerted effort—or perhaps for lack of sufficient interest—to establish them. Decades ago Weisbrod and Schlesinger (1986, p. 147) acknowledged that "designing institutions to reduce the cost of monitoring outputs could be an efficient means for reducing information costs," yet strikingly little progress has been made on this point to date. This is especially puzzling if the purpose of at least some public charities is to produce outcomes and at least some philanthropists desire to maximize beneficiary welfare given limited resources.

Discussion and policy implications

The problem of information costs is fundamentally an accounting problem—the problem of 'accounting for outcomes' (Mitchell, 2013, 2017a). As the Financial Accounting Standards Board (FASB), which issues guidance on nonprofit accounting and financial reporting, notes:

> Information about an organization's service efforts and accomplishments is useful to resource providers and others in assessing the performance of a nonbusiness organization…The accomplishments of nonbusiness organizations generally cannot be measured in terms of sales, profit, or return on investment (FASB, 1980, p. 16).

However, since the FASB began discussions about service efforts and accomplishments in the 1970s, little if any progress on this point has occurred. Due to this impasse, a legitimate question is whether the FASB is an appropriate accounting standard-setter for nonprofits. While financial indicators are important for the financial viability of nonprofits, they are not the primary reason that nonprofits exist, nor should they be the principal basis for informing donor decision-making. Hence, accounting standards that do not focus on specific nonprofit outcomes cannot truly inform "rational decisions about the allocation of resources to those organizations" (FASB, 1980). As such, it is surprising that the nonprofit sector—unlike the public sector, which has the Governmental Accounting Standards Board—lacks its own standard-setter to issue best practices for nonprofit outcome accounting. As posed decades ago, "Are not-for-profit organizations truly so different from for-profit entities that we need additional elements and quite a different financial reporting system? They are indeed" (Mautz, 1989).

One relatively simple means of incentivizing outcome observation is to alter the current accounting treatment of evaluation costs. The accounting definition of program spending could be expanded to include the monitoring and evaluation of "goods or services being distributed"

(Flood, 2018, p. 1323), but this would require a paradigmatic shift toward a financial accounting model more supportive of an instrumental view of the nonprofit sector.

Another potential solution to the outcome accounting problem could be to allocate an organization's total expenses across its own program goals and outcomes analogously to how nonprofits are currently required to allocate their total expenses across functional expense categories (comprised of programs, management and general, and fundraising).[15] The current reporting model based on functional expense accounting operationalizes an expressive philanthropic interest focused on surveilling organizational trustworthiness to the exclusion of accounting for outcomes. The current accounting regime simply does not provide outcome-oriented philanthropists with the most relevant information.[16]

The principal information disclosure mechanism for public charities in the US, the IRS Form 990, does contain a Statement of Program Service Accomplishments (Part III). However, the IRS provides little meaningful oversight over the accuracy of reported information (Keating & Frumkin, 2003) and because program service information is not part of a financial reporting regime, any reported outcome information is, by definition, not audited. Including outcome reporting as part of the existing financial reporting regime could improve the quality of information already reported to the IRS. For such reporting to be meaningful and credible it would need to be informed by agreed-upon accounting standards and audited by bodies with appropriate competence to review outcome information. Neither the standards nor the bodies currently exist.

Additionally, a single set of accounting standards may not appropriately serve the diversity of the nonprofit sector. The current regulatory architecture and financial reporting model focusing on signaling trustworthiness applies to an extremely heterogeneous population of organizations with very different purposes and financial models. For example, large hospitals and universities and other nonprofits that derive significant earned income operate in the same accounting environment as local human service organizations that rely on volunteer labor and donations. Part of the difficulty of developing nonprofit accounting standards stems from the extraordinary diversity of entities that are exempt from taxation under Section 501(c)3. Introducing separate legal designations that subject different types of nonprofit to different regulatory architectures could make nonprofit accounting standards considerably more appropriate and useful. At a more basic level, separate legal architectures could be developed for organizations adopting primarily expressive or instrumental philanthropic functions, with the existing system continuing to serve expressive philanthropy and a new architecture to be carved out for instrumental or outcome-oriented philanthropy. Alternatively, private philanthropists could pool funding into a private 'marketplace' for which funding eligibility would be contingent upon meeting enhanced outcome disclosure requirements.

The significant technological advances that have emerged since the standard theory was originally conceived offer new opportunities for substantially reducing many types of information costs that may have seemed prohibitive in the past. However, without legislative reform, or at least substantial changes to IRS disclosure requirements, credible outcome information will remain scarce as public charities are not required to collect or disclose such information, participation in most data transparency platforms is voluntary, and reported outcome information is not audited.

Unfortunately for outcome-oriented philanthropists, the likelihood for such reform is extremely low. Nonprofits have little incentive to break from the current regulatory and accounting architectures that guarantee them such advantageous financial benefits with so little risk, and warm glow donors similarly lack incentives to expose themselves to the specter of disappointment. Virtually any departure from the status quo would expose nonprofits and donors to more risk and burden. The cycle depicted in Figure 1 is an iron circle that provides obvious mutual benefits to donors and nonprofits. Only beneficiary welfare and government tax losses are disregarded.

Conclusion

By the 1980s economists had begun to ask the fundamental question as to why nonprofits exist at all given that for-profits could presumably accomplish what nonprofits seek to accomplish without the need for another institutional form. According to the standard theory that emerged from this work decades ago, nonprofits exist because they are more trustworthy than for-profits in the production of unobservable outcomes.

If the reason for outcome unobservability is information costs, then stakeholders can seek to mitigate and defray those costs, particularly by taking advantage of relatively new digital capabilities. If, however, nonprofit outcomes are unobservable because they are not real, then nonprofits make no observable difference in the world and perhaps have a less compelling justification for their extremely favorable tax treatment.

There are however at least two other explanations for the existence of nonprofit organizations that merit consideration. First, instrumental outcome production may simply not be the purpose of some or most nonprofit activity, especially considering the predominance of expressive philanthropy, the phenomenon of uniformed giving, and substantial evidence favoring warm glow egoism. The current philanthropic environment in the US is virtually indistinguishable from one in which the purpose of philanthropy is simply to maximize resource provider satisfaction without much regard for the impact of philanthropic activity on beneficiary welfare.

Second, the nonprofit institutional form has another obvious advantage over the for-profit form to explain its continued existence, which is seldom explicitly acknowledged in this context. The public charity is extremely tax-advantaged. Public charities in the US are exempt from federal income taxes, can receive tax deductible contributions, and are usually exempt from many other forms of taxation at other levels of government. Moreover, the IRS exercises considerably less oversight of nonprofits compared to for-profits.[17] These factors alone may explain why nonprofits have appeared in so many different domains of economic activity, including domains where for-profits already exist. Nonprofits may have a notable comparative advantage in trustworthiness, but not having to pay taxes also has its benefits.

Ultimately, what is perhaps most surprising about the lack of an information ecosystem to support outcome-oriented philanthropy in the United States is what it seems to reveal about society's overall values and preferences. How greatly must a society prize individual self-satisfaction, and how little must it value solving other peoples' problems, that observing and accounting for outcomes is not even worth the effort?

Notes

[1] Unless otherwise indicated, the term 'nonprofit' is used to refer to the modal type of donative public charity as described by the 'standard theory' developed by Hansmann (1980) and Weisbrod (1975, 1988; 1986). This excludes most hospitals and universities, for example, which are typically fee-reliant.

[2] Additionally, related innovations in instrumentation also abound, as with the use of social impact bonds and various 'Pay for Performance,' 'Pay for Success,' and 'Payment by Results' schemes, for example.

[3] The term 'outcomes' is here defined expansively to denote anything that an organization produces through the expenditure of inputs. Thus 'outcomes' may also be read as 'results,' 'outputs,' 'impacts,' and so on, as various interpretations may warrant.

[4] Weisbrod (1988, p. 49), for example, provides the following examples of such "commodities" regarding which performance measurement would be too counterproductive to undertake: "Tender loving care in a nursing home; crime prevention by police; national defense."

[5] This formulation represents an extraordinarily strong statement about the nonprofit production function: non-opportunistic spending necessarily improves nonprofit outcomes.

[6] Similarly, Weisbrod (1988, p. 52) notes: "If we reward what we can measure, we distort behavior; if we do not, we discourage efficiency."

[7] For example, federal disclosure rules specifically require nonprofits to report their most highly compensated employees on the IRS Form 990. Media organizations and most nonprofit information intermediaries routinely republish this information.

[8] In all likelihood neither the nonprofit nor the donor has credible information about program outcomes, so the problem is closer to one of information scarcity rather than asymmetry.

[9] For example, see: Charity Navigator (https://www.charitynavigator.org/), the Better Business Bureau Wise Giving Alliance (https://www.give.org/), Christian Science Monitor (https://www.csmonitor.com/), Forbes Magazine (https://www.forbes.com/), and CharityWatch (https://www.charitywatch.org/), among others.

[10] It is not clear why the outcome-return to administrative and fundraising expenditures or ratios should be uniformly nonpositive for all nonprofit production functions, as the normative surveillance architecture implies. The same can be said for officer compensation, debt and reserve ratios, and so forth.

[11] Research frequently finds that resource providers contribute less to nonprofits with less favorable financial indicators such as those used by information intermediaries (e.g. Calabrese, 2011; Calabrese & Grizzle, 2012; Callen, 1994; T. P. Gordon, Knock, & Neely, 2009; Jacobs & Marudas, 2009; J. Khanna, Posnett, & Sandler, 1995; Jyoti Khanna & Sandler, 2000; Kitching, 2009; Marudas, 2004; Marudas, 2015; Marudas & Jacobs, 2004; Okten & Weisbrod, 2000; Posnett & Sandler, 1989; Tinkelman, 1998, 1999, 2004; Tinkelman & Mankaney, 2007; Weisbrod & Dominguez, 1986). Generally, resource providers are present-biased (Charles, 2018; Mitchell & Calabrese, 2018) and favor nonprofits that essentially maximize current program costs. This pattern of financial disclosure, surveillance, and resource provider behavior has contributed to the 'nonprofit starvation cycle' that significantly harms nonprofit effectiveness (Gregory & Howard, 2009; Lecy & Searing, 2015; Mitchell, 2018; Mitchell & Calabrese, 2018; Wing & Hager, 2004a).

[12] Strikingly, the nonprofit economy bears a striking resemblance to what North (1991, p. 103) characterized as the economy of a souk — with "an enormous number of small transactions, each more or less independent of the next; face to face contacts, and goods and services that are not homogenous. There are no institutions devoted to assembling and distributing market information; that is, no price quotations, production reports, employment agencies, consumer guides, and so on. Systems of weights and measures are intricate and incompletely standardized…" In short, the souk is characterized by high information costs, 'clientization' in the form of 'repeat-exchange relationships,' and intensive bargaining. Personal connections, trust, voluntary codes of conduct, and self-regulation govern exchanges.

[13] Mission valence refers to the perceived attractiveness of a mission. See: (Rainey & Steinbauer, 1999; Wright & Pandey, 2011).

[14] North (1987, p. 425) provides an instructive argument about the general necessity of incurring such costs. In "high income societies…impersonal exchange involves the high measurement costs of complex contracting necessary to realize the potential of the technology that comes from specialization. Neither self-enforcement by the parties themselves nor trust is a viable way of enforcing such contracts." Indeed, the US long ago established legal and cultural architectures to defray the information costs necessary for facilitating private capital accumulation, but a similar effort has not yet been devoted to optimizing the production of social outcomes.

[15] Distortion effects and other costs could be further mitigated by allowing nonprofits to select their own measures and methods and to disclose their outcome information to multiple stakeholders in a standardized format (Mitchell, 2013, 2014, 2017a).

[16] Indeed, research has shown that functional expense ratios are uncorrelated with output- or outcome-based efficiency measures. See: (Coupet & Haynie, 2018).

[17] The IRS has experienced declining funding for its Exempt Organizations division, which has led to a reduced examination rate for charitable organizations of 0.71 percent in 2013. This is less than the rate for individuals and is about half the rate of for-profits (GAO, 2014). Additionally, for example, the phenomenon of so-called 'zero cost' fundraising is pervasive (Mitchell, 2017b; Tinkelman, 2004) and the quality of financial reporting on the Form 990 is often poor (Wing & Hager, 2004b). As another example, since 2008, thousands of pastors have participated in 'Pulpit Freedom Sunday,' an annual event in which pastors record themselves demonstrably violating the so-called 'Johnson Amendment' (the provision of IRC Section 501(c)3 that prohibits public charities, including churches, from engaging in political activity) and mailed recordings to the IRS. To date the IRS has never pursued a violation.

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Table 1: Information costs

	Information cost	Description
Supply-side	Distortion	Poor measurement perverts behavior, wasting resources and harming outcomes
	Evaluation	The direct and indirect resource costs of program evaluation
	Disclosure	The costs of publicly reporting information about outcomes in a standardized format
	Auditing	The costs of credibly assuring the accuracy of reported outcome information
Demand-side	Search and discovery	The costs of identifying relevant nonprofits and ascertaining their outcomes and unit costs
	Bargaining and decision making	The costs of information intermediation and comparative analysis to inform allocation decisions
	Surveillance and enforcement	The costs of ensuring accurate disclosure, policing cheating and fraud, and establishing and maintaining reporting standards

Figure 1: Iron circle of resource provider satisfaction