2020

Enhancing Efficiency at Nonprofits with Analysis and Disclosure

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Working Paper No. 626

July 30, 2020

ENHANCING EFFICIENCY AT NONPROFITS WITH ANALYSIS AND DISCLOSURE

By David M. Schizer[1]

Abstract

The U.S. nonprofit sector spends $2.54 trillion each year. If the sector were a country, it would have the eighth largest economy in the world, ahead of Brazil, Italy, Canada, and Russia. The government provides nonprofits with billions in tax subsidies, but instead of evaluating the quality of their work, it leaves this responsibility to nonprofit managers, boards, and donors. The best nonprofits are laboratories of innovation, but unfortunately some are stagnant backwaters, which waste money on out-of-date missions and inefficient programs. To promote more innovation and less stagnation, this Article makes two contributions to the literature.

First, this Article breaks new ground in identifying sources of inefficiency at nonprofits. The literature focuses on incentives, arguing that managers and board members are less motivated to run a nonprofit efficiently because they cannot keep its profits. In response, this Article emphasizes that the problem is not just motivation*, but also* information*. Measuring success is harder at nonprofits. Instead of tracking profitability, they use metrics that are less reliable and harder to measure. These measurement challenges complicate the efforts even of dedicated and competent managers to operate efficiently. While this information problem is familiar, another has been largely overlooked in the literature: When success is hard to measure, incompetence and self-interested practices are less visible, and thus are harder to stop. For example, if managers regularly overpay vendors, the consequence at a for-profit firm (lower profits) is easier to observe than at a nonprofit (less effective service for beneficiaries).*

Second, this Article recommends a response to this underappreciated source of inefficiency: better analysis and disclosure as a strategy for organizational change. In principle, nonprofits are supposed to maximize social return, but how can they operationalize this abstract principle? To help them do so, this Article recommends three questions that nonprofits should answer every year: first, how important are the challenges the nonprofit is trying to address?; second, how effective are the nonprofit's responses to these challenges?; and third, is the nonprofit the right organization to respond to these challenges? These questions press nonprofit managers and boards to be more explicit about priorities, monitor progress, improve and expand high-value programs, and fix or shut down ineffective ones. This Article also recommends that nonprofits should disclose this analysis to the public, even though current law does not require them to do so. This disclosure would empower donors and rating agencies to be more effective monitors. It also would help donors make better informed philanthropic choices and would enable charities to borrow innovative ideas from each other more easily.

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INTRODUCTION

The U.S. nonprofit sector spends $2.54 trillion each year.[2] If the sector were a country, it would have the eighth largest economy in the world, ahead of Brazil, Italy, Canada, and Russia.[3] The government provides nonprofits with billions in tax subsidies,[4] but instead of evaluating the quality of their work, it leaves this responsibility to nonprofit managers, boards, and donors.[5] The best nonprofits are laboratories of innovation, which develop new ways to aid vulnerable populations, strengthen communities, advance frontiers of knowledge, and much more. But unfortunately, some nonprofits are stagnant backwaters, which waste money on out-of-date missions and inefficient programs. To promote more innovation and less stagnation, this Article makes two contributions to the literature.[6]

First, this Article breaks new ground in identifying sources of inefficiency at nonprofits. The literature focuses on incentives, arguing that managers and board members are less motivated to run a nonprofit efficiently because they cannot keep its profits.[7] In response, this Article emphasizes that the problem is not just *motivation*, but also *information*. Measuring

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[2] Brice McKeever, The Nonprofit Sector in Brief 2018, https://nccs.urban.org/publication/nonprofit-sector-brief-2018#the-nonprofit-sector-in-brief-2018-public-charites-giving-and-volunteering [https://perma.cc/UTF6-VSKV] (nonprofits filing Form 990 reported $2.54 trillion of revenue in 2015).

[3] *See* GDP By Country, https://www.worldometers.info/gdp/gdp-by-country/ [https://perma.cc/9KCQ-6RDM].

[4] The two relevant tax rules are the deduction for charitable contributions, *see* I.R.C. §170, and the exemption of a nonprofit's income from tax, *see* I.R.C. §501(a). All references to sections are to the Internal Revenue Code of 1986, as amended. According to the Treasury department's 2020 estimate, the charitable deduction cost the Treasury $57.69 billion in 2020. U.S. Dep't of Treasury, Office of Tax Analysis, Tax Expenditures 24, 25, 31 (Feb. 26, 2020), https://home.treasury.gov/system/files/131/Tax-Expenditures-2021.pdf [https://perma.cc/B8WC-WFZE] ($4.45 billion from charitable contributions to education from individuals and $600 million from corporations; $8.08 billion to hospitals from individuals and $3.81 billion from corporations; $39.54 billion to other charities from individuals and $1.21 billion from corporations). The Treasury does not estimate the revenue loss from the exemption. When a tax rule is called a "subsidy," the tax burden differs from what it otherwise would be under a "regular" regime. This Article assumes that the baseline is an income tax and that taxpayers otherwise would pay tax on resources they give away. *See* David M. Schizer, *Charitable Subsidies and Nonprofit Governance: Comparing the Charitable Deduction With the Exemption For Endowment Income,* 71 Tax L. Rev. 665, 668 n.5 (2018) [hereinafter "*Comparing the Deduction With the Exemption*"].

[5] *See Schizer, Comparing the Deduction With the Exemption, supra* note 4, at 677-82 (noting that exclusion and deduction delegate monitoring to board, donors, and other private parties).

[6] This Article focuses on charitable organizations under I.R.C. §501(c)(3), rather than on other nonprofits, such as advocacy groups, trade associations, and social clubs. The Article focuses on public charities, but also discusses private foundations. The main difference is that public charities have many more donors. *See* I.R.C. §509(a) (defining private foundation). Public charities "are the organizations people usually think of when they hear the word charity," while private foundations are usually "established with funds from a single source . . ., such as family or corporate money." Suzanne Coffman, *Just What Are Public Charities and Private Foundations, Anyway?,* Sept. 1, 2001, https://trust.guidestar.org/just-what-are-public-charities-and-private-foundations-anyway [https://perma.cc/E27U-P96W].

[7] Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 Yale L. J. 835,844 (1980) ("Of course, one would expect that when the profit motive is eliminated a price is paid in terms of incentives.") [hereinafter "*Nonprofit Enterprise*"]; Burton A. Weisbrod, The Nonprofit Economy 23 (1988) ("Nonprofit managers may also have less incentive to be efficient, since efficiency cannot lawfully be rewarded.") [hereinafter "Nonprofit Economy"]; Dennis R. Young, If Not For Profit, For What? 130 (1983) ("A commonly held view is that nonprofits maintain quality but produce services in a relatively wasteful fashion"); *id.* at 129 (attributing this "sluggishness" to lack of profit motive and capital constraints).

success is more difficult at nonprofits. Instead of tracking profitability, nonprofits depend on metrics that are harder to measure and less reliable.[8] These measurement challenges complicate the efforts of even dedicated and competent managers to operate efficiently.[9] While this information problem is familiar,[10] another has been largely overlooked in the literature: When success is hard to measure, incompetence and self-interested practices are less visible, and thus are harder to stop. For example, if managers regularly overpay vendors, the consequence at a for-profit firm (lower profits) is easier to observe than at a nonprofit (less effective service for beneficiaries).[11]

Second, this Article recommends a response to this underappreciated source of inefficiency: better analysis and disclosure as a strategy for organizational change. In principle,

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8 *See, e.g.*, Mary Kay Gugerty & Dean Karlan, The Goldilocks Challenge viii (2018) ("the trend to measure impact has brought with it a proliferation of poor methods of doing so, resulting in organizations wasting huge amounts of money on 'bad impact evaluations'"); Burton A. Weisbrod, *An Agenda for Quantitative Evaluation of the Nonprofit Sector, in* Measuring the Impact of the Nonprofit Sector (Patrick Flynn & Virginia A. Hodgkinson ed.) 274 (2001) [hereinafter "*Measuring Impact*"] ("If measuring the nonprofit sector's benefits and costs, advantages and disadvantages is not done well, it will likely lead to erroneous decisions. Done well, it will likely be expensive and time consuming.") [hereinafter *"Quantitative Evaluation"*].

9 *See, e.g.,* Raj Kumar, The Business of Changing the World 59-60 (2019) (calling "a set of standard universal metrics that would allow us to make true apples to apples comparisons between different kinds of organizations" the "holy grail" because [w]e're not going to find it"); Michael M. Weinstein & Ralph M. Bradburd, The Robin Hood Rules for Smart Giving 14 (2013) (evidence of a program's impact "can be incomplete, imprecise, and sometimes downright atrocious.").

10 In the literature, information problems are invoked not only to show the difficulties faced by even the best nonprofits in measuring impact, *see supra* note 8 & 9, but also in justifying the use of the nonprofit form. *See, e.g.,* Hansmann, *Nonprofit Enterprise, supra* note 7, at 843-44 ("Yet occasionally . . . consumers may be incapable of accurately evaluating the goods promised or delivered. . . . In situations of this type, consumers might be considerably better off if they deal with nonprofit producers" since nonprofits "lac[k] the incentive to [raise prices or cut quality] because those in charge are barred from taking home any resulting profits").

11 A few commentators have considered how information problems complicate efforts to monitor nonprofit managers, but have deemed these problems to be either less important than the incentive problems emphasized in the literature or a consequence of them. *See* Geoffrey A. Manne, *Agency Costs and the Oversight of Charitable Organizations,* 1999 Wisc. L. Rev. 227, 227, 268 (1999) (noting that "charitable goals are ambiguous, or, at least, difficult to quantify" and "there is no easy mechanism by which to monitor the efficacy of the nonprofit's activities," but still referring to "the absence of residual claimants" as "the primary problem inherent in the nonprofit form"); Aseem Prakash & Mary Kay Gugerty, *Trust But Verify? Voluntary Regulation Programs in the Nonprofit Sector*, 4 Regulation & Governance 22, 25-26 (2010) (observing that information asymmetries are "particularly acute" at nonprofits and offering incentive-based explanations, including the lack of "residual claimants with private incentives to monitor," as well as "the absence of a merger and acquisitions market in the nonprofit sector [which] further reduces incentives"). George Triantis has also observed that information asymmetry can exacerbate nonprofit agency costs, but in a somewhat different context. In analyzing when for-profit and nonprofit firms should segregate assets (*e.g.,* with separate entities, security interests, or restricted donations), Triantis argues that asset segregation can limit agency costs, but at the cost of keeping managers from responding to new information. Triantis considers this tradeoff to be especially stark at nonprofits: on the one hand, managers have a greater need to reallocate resources, since they face greater challenges in demonstrating the value of charitable opportunities to outsiders; on the other hand, these same challenges exacerbate agency costs. George G. Triantis, *Organizations as Internal Capital Markets: The Legal Boundaries of Firms, Collateral, and Trusts in Commercial and Charitable Enterprises,* 117 Harv. L. Rev. 1102, 1147 (2004) ("information asymmetry is a greater obstacle to external finance in the charitable sector than it is in the commercial sector," but information asymmetry "also makes agency costs less tractable").

nonprofits are supposed to maximize social return, but how can they operationalize this abstract principle? To help them do so, this Article recommends three questions that nonprofits should answer every year: first, how important are the challenges the nonprofit is trying to address?; second, how effective are the nonprofit's responses to these challenges?; and third, is the nonprofit the right organization to respond to these challenges? These questions press nonprofit managers and boards to be more explicit about priorities, monitor progress, improve and expand high-value programs, and fix or shut down ineffective ones.

This Article also recommends that nonprofits should disclose this analysis to the public, even though current law does not require them to do so. This disclosure empowers donors and rating agencies to be more effective monitors. It also helps donors make better informed philanthropic choices and enables charities to borrow innovative ideas from each other more easily. Admittedly, these benefits come at a cost: the time and effort invested in preparing the analysis and in policing the accuracy of disclosure. To balance these competing considerations, this Article recommends that this analysis and disclosure should be mandatory for large public charities and voluntary for other nonprofits.

This recommendation is somewhat out of step with recent work criticizing mandatory disclosure. For example, Professors Ben-Shahar and Schneider warn that "disclosees often do not read disclosed information" and "do not understand it when they read it."[12] Yet these concerns loom larger with unsophisticated consumers (*e.g.,* of health care or credit cards).[13] The goal here is not to protect an unsophisticated audience from being duped, but to recruit a sophisticated audience of donors and rating agencies as monitors.[14]

Although the focus here is on nonprofits, this Article also has implications for for-profit firms and, in particular, for the debate on stakeholder capitalism. Proponents urge for-profit firms to pursue goals other than profitability, such as enhancing the wellbeing of employees and their communities.[15] Yet in taking on these responsibilities, for-profit firms face the same challenges

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[12] Omri Ben-Shahar & Carl E. Schneider, *The Failure of Mandated Disclosure*, 159 U. Pa. L. Rev. 647, 651, 665 (2011); *see also* Omri Ben-Shahar & Carl E. Schneider, More Than You Wanted to Know: The Failure of Mandated Disclosure (2014); David E. Pozen, *Transparency's Ideological Drift,* 128 Yale L. J. 100 (2018) (measures to promote transparency used to pursue pro-regulatory agenda, but now often advance deregulatory agenda); Joshua Mitts, *How Much Mandatory Disclosure is Effective?* (October 4, 2014), http://dx.doi.org/10.2139/ssrn.2404526 (arguing that question is not *whether* to require disclosure, but *how much* of it to require).

[13] These are two of their "paradigmatic cases." Ben-Shahar & Schneider, *supra* note 12, at 665-72.

[14] Professors Ben-Shahar and Schneider acknowledge the value of disclosure "aimed directly at sophisticated intermediaries . . . where the presence of such intermediaries produces a desirable effect for the nonreading populous." *Id.* at 732. One of their examples of this is disclosure to investors. *Id.*

[15] *See, e.g.,* Business Roundtable, Statement on the Purpose of a Corporation, Aug. 19, 2019, https://opportunity.businessroundtable.org/wp-content/uploads/2019/08/BRT-Statement-on-the-Purpose-of-a-Corporation-with-Signatures.pdf ("we share a fundamental commitment to all of our stakeholders"); Elizabeth Warren, *Companies Shouldn't Be Accountable Only to Shareholders*, Wall St. J., Aug. 14, 2018 (advocating legislation requiring "corporate directors to consider the interests of all major corporate stakeholders — not only shareholders"); Addisu Lashitew, *Stakeholder Capitalism Arrives at Davos*, Brookings, Jan. 21, 2020 (noting "an emerging shift away from the paradigm of 'shareholder capitalism' that has guided the world economy since the 1970s"), https://www.brookings.edu/blog/future-development/2020/01/21/stakeholder-capitalism-arrives-at-davos/ [https://perma.cc/4T7X-MPUS].

that this Article identifies at nonprofits: success becomes harder to measure, so mismanagement is harder to stop. This risk complicates the case for stakeholder capitalism, and creates a need for something like the analysis and disclosure proposed here in any effort to operationalize it.

Part I investigates the unique sources of inefficiency at nonprofits. Part II considers which stakeholders are best positioned to press for efficiency, and chooses boards, donors, and rating agencies to play this role. To help nonprofits run more efficiently, Part III proposes a rigorous planning process, in which managers and boards analyze the impact and cost-effectiveness of programs by answering three questions. Part IV urges nonprofits to share their answers with the public. Part V recommends mandating this disclosure for public charities with annual budgets over $10 million. Part VI is the conclusion.

I. SOURCES OF INEFFICIENCY AT NONPROFITS: INCENTIVES AND INFORMATION

This Part considers the unique challenges nonprofits face in striving to operate efficiently. While the literature focuses on flawed incentives,[16] this Article emphasizes information problems.

A. Flawed Incentives as a Source of Inefficiency: The Nondistribution Constraint

The defining feature of nonprofits is their bar on distributing profits. The literature regards this "nondistribution constraint" as both a governance blessing and a curse. Since managers and board members cannot share in profits, they are less motivated to cheat beneficiaries and donors, but they also have less incentive to operate efficiently.

1. Nondistribution Constraint Builds Trust

In path-breaking work, Henry Hansmann has shown how the nonprofit form overcomes information asymmetry. Since managers and board members do not have a financial incentive to take advantage of beneficiaries and donors,[17] beneficiaries trust them not to overcharge or skimp

[16] Henry Hansmann, *Economic Theories of the Nonprofit Sector*, *in* The Nonprofit Sector 29 (Walter Powell ed. 1987) [hereinafter *"Economic Theories"*] (nonprofits have less incentive to cut costs); Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N.Y.L. Sch. L. Rev. 457, 465 (1996) (as a legal matter, donors are not owners) [hereinafter "*Agents Without Principals*"].
[17] Hansmann, *Nonprofit Enterprise, supra* note 7, at 844 ("The nonprofit producer . . . lacks the incentive to [raise prices and cut quality] . . . because those in charge are barred from taking home any resulting profits. ").

on quality.[18] Likewise, funders buy goods and services for third parties without confirming receipt[19] or knowing the incremental impact of their contributions.[20]

Admittedly, nonprofit managers and boards can still behave in self-interested ways, which are well understood. Managers can claim overly-generous pay, engage in nepotistic hiring, pursue "pet" projects, and set a relaxed pace, while board members can claim a range of private benefits.[21] Yet the nonprofit form still provides some reassurance to beneficiaries and donors.

2. Nondistribution Constraint Breeds Inefficiency

Even so, the literature also emphasizes a downside to the nondistribution constraint: since managers and board members do not benefit financially from increasing revenue or cutting costs, they have less reason to make hard choices.[22] After all, saying "no" to colleagues, grantees, and vendors is harder than saying "yes." Pushing them to perform better can be unpleasant, as is severing ties with those who don't measure up.

In addition to sapping their motivation, the nondistribution constraint also insulates managers and boards from external scrutiny. Since there are no owners to demand a distribution, managers and boards retain control of any resources they do not spend.[23] They can use these

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[18] Henry Hansmann, The Ownership of Enterprise 228 (1996) [hereinafter "*Ownership*"] ("nonprofit firms commonly arise where customers are in a particularly poor position to determine, with reasonable cost or effort, the quality or the quantity of the services they receive from a firm."). Admittedly, beneficiaries are reassured by the nondistribution constraint only when they understand its significance. *See* Prakash & Gugerty, *supra* note 11, at 27 (noting evidence that consumers "have limited understanding of what the nonprofit form entails").

[19] Hansmann, *Nonprofit Enterprise*, *supra* note 7, at 847 (funding disaster relief thousands of miles away).

[20] Ira Ellman, *Another Theory of Nonprofit Corporations*, 80 Mich L. Rev. 999, 1010 (1982) (donors do not know if their personal contribution enhanced either quality or quantity); Hansmann, *Economic Theories, supra* note 16, at 30 (nonprofits are used when "collective consumption goods produced in such aggregate magnitude that the increment purchased by a single individual cannot be easily ascertained"); Hansmann, *Nonprofit Enterprise, supra* note 7, at 851.

[21] Brody, *Agents Without Principals, supra* note 16, at 493; Hansmann, *Economic Theories, supra* note 16, at 38 (there is evidence that nonprofit managers seek nonpecuniary perquisites); Hansmann, *Nonprofit Enterprise, supra* note 7, at 875 (noting various ways nonprofits managers can indirectly share in profits).

[22] Henry Hansmann, *The Economics of Nonprofit Organizations*, in Comparative Corporate Governance of Nonprofit Institutions 60, 64 (Klaus J. Hopt ed.) (2010) [hereinafter "*Economics*"} ("The principal forms that managerialism might be expected to take in nonprofit organizations are a general failure to minimize costs and a bias toward excessive quality and/or quantity."); Hansmann, *Nonprofit Enterprise, supra* note 7, at 878 ("Nonprofits might therefore be expected to be less vigilant in eliminating unnecessary expense than are their for-profit counterparts."); Anup Malani, Tomas Philipson & Guy David, *Theories of Firm Behavior in the Nonprofit Secto*r in The Governance of Not For Profit Organizations (Edward L. Glaeser, ed.) 192 (2003) ("NFP [not-for-profit] firms invest less effort in cost-cutting effort because the returns to such investment are lower.").

[23] Hansmann, *Economics, supra* note 22, at 64 ("The absence of owners . . . means that managers are largely free of outside discipline."). To an extent, the tax law limits this discretion in private foundations by requiring minimum distributions. I.R.C. §4942 (private foundations must make grants equal to at least 5% of their endowment each year). This requirement does not apply to public charities.

funds to run inefficiently — sometimes for years — until the money is all gone.[24] The market for corporate control is unlikely to stop them.[25]

Yet although the literature emphasizes flawed incentives as a key source of inefficiency at nonprofits, this incentive problem should not be overstated for two reasons. First, although managers and board members cannot share in profits, they still have familiar reasons to be efficient, including their professional reputations, as well as their commitment to the nonprofit's mission.[26] Second, they usually also face an important external pressure to perform: they need to raise money.

B. Flawed Information as a Source of Inefficiency: Social Return is Hard to Measure

Although the literature attributes inefficiency at nonprofits to imperfect *motivation*, this Article emphasizes that it derives also from imperfect *information*. In other words, information problems are not only a *justification* for nonprofits, as the literature emphasizes, but also a *key source of their inefficiency* for two reasons. First, unlike for-profit firms, which measure success with financial return, nonprofits have to track social return, which is more difficult. This measurement challenge, which is well understood, complicates the efforts of even the best management teams and boards to allocate resources efficiently.[27] Second, this measurement challenge has another effect that the literature has largely overlooked: when managers and board members are less capable and committed, the flaws in their choices are harder to detect.

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[24] Hansmann, Ownership, *supra* note 18, at 241 ("In short, capital tends to get locked into nonprofit firms."). Restrictions on the endowment can be a further source of inefficiency, to the extent that they keep the board and managers from moving in a more productive direction.

[25] Henry Hansmann, *A Reform Agenda for the Law of Nonprofit Organizations*, in Klaus Hopt & Dieter Reuter, eds., Stiftungsrecht in Europa 241, 256 (Carl Heymanns Verlag, 2001) [hereinafter "*Reform Agenda*"] ("[H]ostile takeovers of nonprofit firms are today essentially impossible."). In principle, a hostile takeover might be feasible at "mutual" nonprofits, whose boards are not self-perpetuating, and instead are elected (and removed) by members. *Cf.* Ellis Carter, Nonprofit Jargon Buster -- Voting Members Versus Self Perpetuating Boards, Charity Lawyer Blog, April 26, 2011, https://charitylawyerblog.com/2011/04/26/nonprofit-law-jargon-buster-voting-members-vs-self-perpetuating-boards/ [https://perma.cc/Y4GY-7FXV] (donors and beneficiaries do not choose directors, except at "mutual" nonprofits).

[26] Hansmann, *Economic Theories, supra* note 16, at 29 n. 5 ("The nondistribution constraint . . . screen[s] for managers who place an unusually low value on pecuniary compensation and an unusually high value on having the organization they run produce large quantities of services or services that are of especially high quality"); Weisbrod, Nonprofit Economy, *supra* note 7, at 23 ("if managers of nonprofits derive relatively greater personal satisfaction than their proprietary counterparts do from providing a particular service, then there would be an incentive for nonprofit managers to be efficient even though they cannot benefit financially").

[27] *See, e.g.,* Gugerty & Karlan, *supra* note 8, at 5 (noting that "the struggle to find the right fit in monitoring and evaluation systems resembles the predicament Golidlocks faces" in that some organizations collect too much data and do not use it, while other organizations do not collect enough data); Weinstein & Bradburd, *supra* note 9, at 14 (evidence of a program's impact is often incomplete or flawed); Kumar, *supra* note 9, at 42, 49 (noting "increasing demand for results" and that "good results are hard to find," while observing that "[o]rganizations are beginning to showcase their cost-effectiveness at a granular level by using independent, serious research"); Acumen Fund Metrics Team, *Best Available Charitable Option*, January 2007, at 2 https://acumen.org/wp-content/uploads/2013/03/BACO-Concept-Paper-final.pdf ("finding a standard metric to measure the success of a social investment has been a vexing challenge").

1. *Measuring Success at For-Profit Firms is Relatively Straightforward*

Measuring success at for-profit firms is much easier than at nonprofits. In general, for-profit firms seek to maximize profits and share prices. There are well understood and widely accepted conventions for computing earnings. At public companies, share prices also are easy to access. Both metrics can be used to compare the success of different firms, and earnings can be used to compare initiatives within the same firm. Compensation contracts can draw on these metrics to align the incentives of managers, board members, and shareholders.

This is not to say that earnings and share prices are a bullet-proof solution to every governance challenge at for-profit firms. Stakeholders sometimes disagree about the reliability of these metrics in particular circumstances and about how to compute them. In measuring profitability and share prices, is the right time horizon the current quarter or a longer period? Causation also can be an issue. Was the quarter's profit low because managers pursued a flawed strategy, or because of unusual market conditions. To answer this question, stakeholders want to know how comparable firms performed, but they may differ on which firms are comparable. Moreover, even if they agree about the past, they may offer different predictions about the future.

There also is a debate about whether for-profit firms should pursue goals other than profitability. Proponents of "shareholder primacy," such as Milton Friedman, the late Nobel prize-winning economist, urge businesses to focus on profitability. For-profit managers and boards should not "spend other people's money" on "general social interests," since they lack the expertise to do so, as well as criteria to mediate among competing goals; instead, this responsibility should be left to the government and nonprofits.[28] In contrast, advocates of "stakeholder capitalism," such as Larry Fink, the CEO of Blackrock, want for-profit firms not only "to deliver financial performance," but also to "benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate."[29]

But as important as these disagreements can be, they are bounded. At the end of the day, everyone agrees that profitability and market value are key measures of performance at a for-profit firm (even if some do not consider them the *only* measures). Likewise, everyone agrees on the broad outlines of how to compute these metrics. Debates in for-profit firms typically reduce to the same question: which alternative maximizes the firm's profitability and market value?

2. *Measuring Success at Nonprofits is More Challenging*

In contrast, nonprofits cannot use profitability or share prices to measure success, since the main role of nonprofits is to address market failures. They step in when there is no cost-effective way to charge for valuable goods and services — as is the case with parks, basic research, and other public goods. Nonprofits also serve needy beneficiaries who lack the means to pay. Since the whole purpose of a nonprofit is to run initiatives that the market does not fund adequately, operating revenue is a flawed measure of a nonprofit's social value.

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[28] Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, N.Y. Times Magazine, Sept. 13, 1970.

[29] https://www.blackrock.com/hk/en/insights/larry-fink-ceo-letter (Jan. 2018 letter to shareholders) [https://perma.cc/7ZMJ-XZ3N].

Likewise, a nonprofit's fundraising totals are not always a reliable measure of its social value. Sometimes the willingness of donors to contribute reflects the value of a nonprofit's work, but sometimes it merely shows that the nonprofit invests heavily in fundraising. Attracting donations is a more dependable measure of quality when donors are well informed about the nonprofit's work.

In principle, the right measure of a nonprofit's success is its social return. How much good does it do in the world?[30] Even so, measuring social return is less precise — and, frankly, much messier — than measuring financial return. How do we calculate it for a church, soup kitchen, or university? There is no uniform and consensually accepted way to do so. As Albert Einstein supposedly said, "Not everything that counts can be counted, and not everything that can be counted counts."[31]

To be clear, the argument here is not that inefficiency at nonprofits is *inevitable*; on the contrary, this Article suggests ways for them to run more efficiently. Rather, the point is that nonprofits face unique challenges in pursuing this goal, which are rooted in difficulties in measuring progress.

These measurement challenges complicate the management of nonprofits in five important ways, which arise even when an organization's managers and board are committed and competent, so there is no risk of mismanagement. First, unlike for-profit firms, nonprofits cannot easily compare the value of different missions. At for-profit firms, profitability tells us whether to invest in real estate, energy, bio-tech, or software. At nonprofits, by contrast, there is no common metric to compare student financial aid, medical research, soup kitchens, art museums, and public interest litigation.[32] Unlike at for-profit firms, data alone cannot determine their relative value; instead, any ranking turns in part on subjective values and preferences. As a result, evaluating the importance of the mission becomes much more difficult.

Second, like comparing two missions, comparing two ways to advance the *same* mission poses analogous challenges. Which goals should be prioritized? For instance, if the mission is poverty relief, should the nonprofit help vulnerable populations in U.S. inner cities or in Venezuela? Should the focus be on children or on elderly? Once the nonprofit chooses the population it wishes to help, what programs should it run? For example, should it provide food or medicine? Fortunately, comparing options to advance the *same* mission (*e.g.,* poverty relief in the U.S. or Venezuela) is somewhat easier than comparing *different* missions (*e.g.,* poverty relief versus medical research), since data becomes more useful. In this example, the nonprofit can compare the standard of living of various populations, as well as the impact and cost of different

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[30] *See* Gugerty & Karlan, *supra* note 8, at 6 ("Unlike for profit companies with no stated social impact goal, nonprofits and social enterprises claim to make a positive impact on the world.").
[31] https://quoteinvestigator.com/2010/05/26/everything-counts-einstein/ [https://perma.cc/8DAL-5XEH] (attributing quote to William Cameron).
[32] Weinstein & Bradburd, *supra* note 9, at 3 ("A basic problem that plagues philanthropic decisions is that there is no natural yardstick by which to measure, and thus compare, different philanthropic outcomes."); Kumar, *supra* note 9, at 60 (noting that a universal metric for nonprofits is impossible); Young, *supra* note 7, at 127 ("Within present limits of social science knowledge, application of a single global criterion of social welfare is untenable.").

interventions. Yet the relevant findings are not always definitive (*e.g.,* in comparing the relative value of food versus medicine), and decisions are still likely to turn on contestable value judgments. For instance, should the focus be on children because they represent the future? Or on elderly because this is the last opportunity to help them? These moral dilemmas do not arise when for-profit firms decide whether to provide consumer products to children or elderly. Rather, a for-profit firm simply asks which market is more lucrative.[33]

Third, the inability to measure success with profitability is a challenge not only in picking a mission and in setting program priorities, but also in evaluating specific programs.[34] How can nonprofits tell whether their programs are working? Unlike for-profit firms, which can use profitability to answer this question, nonprofits need other metrics that are reliable and easy to track.[35] Yet as the following example shows, there is often a tradeoff between reliability and cost:

> To strengthen civil society in a disadvantaged community, a nonprofit launches a new leadership training program. The goal is to train community members to develop and lead promising new grassroots initiatives. How do the nonprofit's stakeholders know whether this initiative is successful?

A relatively easy way to evaluate this program is to ask participants to rate different aspects of it and suggest improvements. Yet although a survey is inexpensive, it offers only limited information. The real test is not what participants *thought* of the program, but what they *actually did* after completing it. To shed light on this issue, the nonprofit can compare the communal contributions of program participants and a control group over time.[36] This alternative is a better measure of the program's long-term impact, but it is much costlier and slower.[37]

Fourth, since nonprofits cannot rely on profitability to define success, and must use other metrics instead, there is a risk that they will choose flawed metrics which induce them to misallocate resources.[38] After all, in the words of Peter Drucker, a prominent expert on management, "what gets measured gets done."[39] In the example above, participant surveys might

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33 Weinstein & Bradburd, *supra* note 9, at 4 ("capitalists don't care if they earn a dollar's worth of profits by selling potato chips or computer chips").

34 *See* Kumar, *supra* note 9*,* at 43 (stressing importance of evaluating programs and recommending "results-oriented approach" in which a nonprofit uses a pilot study to test results and then rolls out initiative iteratively, updating each phase with lessons from the prior phase).

35 *See* Gugerty & Karlan, *supra* note 8, at 8 (showing how challenging it is to evaluate programs by highlighting "three traps in . . . monitoring and evaluation efforts": collecting too little data, collecting more data than the organization has the capacity to use, and collecting the wrong data, which "does not allow them to know if the organization *caused* the changes" the relevant program is seeking).

36 *See id.* at 5 ("Without [a comparison group], it is quite challenging to know whether the program caused the observed changes to occur.").

37 *See* Kumar, *supra* note 9*,* at 51 ("Drawbacks [of randomized control trials] include cost and lost time, and the inability to translate lessons from one context to another.").

38 Weisbrod, *Quantitative Evaluation, supra* note 8, at 275 ("The danger is that easily measured outputs or outcomes will be measured while others remain unmeasured and, in effect, valued at zero. Resources will then be misallocated.").

39 Weinstein & Bradburd, *supra* note 9, at 15 (quoting Drucker).

motivate nonprofits to overemphasize program features, such as extravagant venues, which inspire positive evaluations but do not contribute much to social return.

Finally, since nonprofits cannot measure success with profitability, analyzing opportunity cost is more difficult for them. In the example above, even if a training program yields positive results, another alternative might have been better still. To make this judgment in for-profit firms, managers can require new projects to exceed a "hurdle rate," such as the average return from other projects. At nonprofits, by contrast, operationalizing a hurdle rate is difficult. Instead, the best a nonprofit can do is develop various options for pursuing a goal, and try to choose the best one.[40]

C. Flawed Information as a Source of Inefficiency: Mismanagement is Harder to Detect

The last Section showed that allocating resources efficiently can be challenging even for the best nonprofit managers and board members, since they cannot use profitability to measure success. This Section shows that if these stakeholders are self-interested or incompetent, this information problem imposes still another cost, which the literature has largely overlooked: When success is hard to measure, mismanagement is less visible, and thus is harder to stop. In other words, challenges in measuring success breed inefficiency not only in obliging faithful agents to do their best with imperfect information, but also in giving disloyal or inept agents license to misuse their authority. To make this case, this Section surveys four challenges: agency costs, incompetence, conflict, and inertia. While these problems also arise at for-profit firms, they are likely to be more acute at nonprofits because success is harder to measure.

1. Agency Costs

Needless to say, the interests of employees and board members sometimes diverge from those of the organization. Blocking a self-interested choice is not easy at for-profit firms, but it can be even harder at nonprofits. At both types of firms, managers and board members seldom admit that their decision is motivated by self-interest, perhaps even to themselves. Instead, they defend it as good for the organization. The right response is to expose their choice as bad for the organization and good only for them personally. This showing is harder when success at the organization is more difficult to measure.

For example, assume an organization has to eliminate one of two lines of business for budgetary reasons. Looking for a slower pace and less stress, managers want to cut the one that is harder to run, even though it adds more value. To justify this self-interested choice, they try to mischaracterize the high-value (and difficult) line of business as low-value.

How easy is it to expose this decision as self-interested? If a firm's success is measured in profits, the relative value of the two businesses is transparent: the one that is harder to run generates more profit. Invoking this information, which is relatively easy to access, board

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[40] *See, e.g.,* Acumen Fund Metrics Team, *supra* note 27, at 3 ("Rather than seek an absolute standard . . ., Acumen Fund . . . quantif[ies] an investment's social impact and compare it to . . . existing charitable options").

members and shareholders can challenge this choice, questioning why management wants to close the more profitable business.

However, if success is measured in social return, instead of profitability, assessing the relative value of the two initiatives is much more difficult. Granular information is needed about the impact and cost-effectiveness of these programs, and board members, donors, and other nonprofit stakeholders usually depend on management for this information. As a result, these stakeholders are less able to discern – and, for that matter, to make the case – that management's choice is self-interested. In this less transparent environment, managers have more latitude to prioritize their own interests.

The opacity of social return can provide "cover" for any number of other self-interested choices as well.[41] When performance is hard to measure, basing personnel decisions on friendship (or animosity) is more feasible. Likewise, questionable travel, overstaffing, expensive offices, and other wasteful expenditures are easier to justify when the asserted benefits are hard to quantify.[42]

In theory, incentive compensation could discourage self-interested choices, but the most common versions at for-profit firms — stock options, equity grants, and bonuses based on earnings — are unavailable. Indeed, a bonus for generating a surplus could jeopardize a nonprofit's tax-free status. Instead, a bonus must be based on other benchmarks, such as program-related targets. Yet these benchmarks can align incentives only if they are reliable measures of success. As a result, challenges in measuring success undercut the effectiveness of incentive compensation at nonprofits.[43]

Admittedly, incentive compensation is less necessary with employees who are committed to the mission. Indeed, some nonprofit managers are so dedicated that they forgo more lucrative jobs at for-profit firms. Self-motivated employees arguably need less monitoring; even when they have latitude to pursue their self-interest, they might still prioritize the mission.[44]

Yet unfortunately, this commendable impulse is not universal. As a counter example, some employees could become embittered about lucrative paths not taken, rendering them all the more motivated to take advantage. Agency costs surely are a problem with *at least some* nonprofit employees, and monitoring them is harder because of difficulties in measuring success.

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[41] *Cf.* Young, *supra* note 7, at 118 ("nonprofit ventures often operate under vague performance criteria and loose control" that "leave substantial room for discretionary behavior . . . to indulge in self-defined motives and goals"). Young does not focus on the risk of abusing this autonomy, calling managers' goals "self-defined," not "self-interested."

[42] Of course, some self-interested practices are not harder to monitor at nonprofits (*e.g.*, embezzlement and self-dealing) and require the same responses (*e.g.*, internal controls and conflict-of-interest policies).

[43] *See* Kumar, *supra* note 9, at 40 ("good evidence is hard to find").

[44] Hansmann, *Nonprofit Enterprise, supra* note 7, at 876 ("the nondistribution constraint . . . screen[s] selectively for . . . employees who are more interested in providing high-quality service and less interested in financial rewards").

2. *Incompetence*

Even when managers and board members *want* to put the organization's interests first, they do so *ineffectively* if they have poor judgment, weak analytical abilities, flawed interpersonal skills, low energy levels, or other deficiencies. Nonprofits are no different from for-profit firms in rooting out incompetence that is easy to observe, such as missed deadlines, perennial tardiness, rudeness, and personal calls at work.

Yet nonprofits face greater challenges in evaluating employees in a deeper way. After all, for-profit firms can evaluate most managers based on the profits they generate. Admittedly, this calculation can be challenging, since causation is sometimes unclear. Market conditions beyond a manager's control may inflate or erode profitability, and the relative contribution of different managers can be debated. But these challenges arise equally at nonprofits, along with a more fundamental one, which is unique to charities: since the *organization's* success is hard to measure, *an individual's contribution* to that success is all the more difficult to assess.

Notably, while a manager or board member's commitment to the cause can prevent her from making *self-interested* choices, she can still make *unwise* ones. Even idealists can be inept. In the above example, when managers and board members must shut down one of two lines of business, they may choose the wrong one — not because they are angling for the easier path — but because they misjudge which offers a better social return. Unfortunately, intense philosophical commitments can breed overconfidence, inducing some nonprofit managers to resist empirical evaluations of their work, as well as changes in priorities and programs.[45]

Clear and measurable goals are needed not only to monitor employees, but also to motivate them. "When people have conflicting priorities or unclear, meaningless, or arbitrarily shifting goals," a prominent venture capitalist has observed, "they become frustrated, cynical, and demotivated."[46] Again, nonprofits need to work harder to articulate and track these goals.

3. *Conflict*

Another challenge at both for-profit and nonprofit firms is conflict. At well-run organizations, key stakeholders resolve disagreements amicably, basing decisions on information and analysis, not on politics and personalities. Lines of authority are clear, and the losing side accepts the decision and helps to implement it. The two sides do not become warring factions.

At first blush, conflict may seem less likely at nonprofits, since key stakeholders all believe in the mission. But in fact, this shared commitment can make conflict more corrosive, since fights about principle are often more heated and harder to settle than fights about profit. Bitter clashes can arise about how to interpret the mission.[47] For example, some environmental organizations oppose nuclear power as a source of radioactive waste, while others support it as

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[45] I thank Louis Kaplow for this point.

[46] John Doerr, Measure What Matters 5 (2018).

[47] Young, *supra* note 7, at 114 ("board members, clients, and resource providers may all have their own ideas and preferences with respect to the purposes of the organization and programs").

carbon-free energy. Donors who favor one interpretation ("no nukes!") can become quite disillusioned in inadvertently supporting the other ("no carbon!"). This sort of misunderstanding is much less likely at for-profit firms, since the mission — maximizing profits — is clear to all.

Even when nonprofit stakeholders agree on the mission, they still might disagree on how to advance it. These disputes can be hard to resolve, especially if the relevant evidence is not definitive enough to change someone's mind.

4. Inertia

Finally, another challenge at both for-profit and nonprofit firms is resistance to change. Ironically, the same factors that initially help an organization succeed can breed inertia. According to Michael Hannan and John Freeman, organizations need standard operating procedures to succeed, but these routines later become hard to change, even when a new approach is urgently needed.[48]

Change involves effort and risk. Managers have to design new approaches, develop different skills, replace personnel, and acquire new assets.[49] If a new initiative fails, reputations suffer. Obviously, the status quo is also risky, but stakeholders may still prefer "the devil they know." After all, they are less likely to be blamed – by the media, rivals within the organization, the board, funders, and potential future employers — for sticking with a strategy that used to work.

At for-profit firms, when managers and board members have outdated confidence in the status quo, declining profits and stock prices can force them to face reality. Yet at nonprofits, there are no comparably clear "wakeup calls." In some cases, beneficiaries respond by defecting to other nonprofits, but only if the market is competitive enough to support alternatives. In other cases, donors respond by reducing their donations, but only if they are motivated and knowledgeable enough to realize that the nonprofit is ineffective.

In combating inertia, the commitment of nonprofit stakeholders to the mission is a mixed blessing. On the one hand, this idealism can steel them to make painful choices. On the other hand, they may find it upsetting to admit, either to themselves or to others, that past efforts and donations – once the source of great pride and satisfaction — actually were wasted. Even after better alternatives have emerged, they may remain irrationally wedded to their mission or the minutiae of how they have pursued it.[50] For example, their passion for helping needy people may evolve into passion for helping them *in a particular way*, which is no longer cutting edge.[51] In

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[48] Michael T Hannan & John Freeman, *Structural Inertia and Organizational Change*, 49 Am Soc. Rev. 149, 154 (1984) ("The very factors that make a system reproducible make it resistant to change.").

[49] *Id.* at 154 ("It is easier to continue existing routines than to create new ones or borrow old ones.")

[50] *Cf.* Young, *supra* note 7, at 108 ("Nonprofit agencies . . . may be substantially affected by both the sentimental loyalties of longstanding board members and by the conservative interests of staff").

[51] *Cf.* Hannan & Freeman, *supra* note 48, at 149 (discussing "the tendency of precedents to become normative standards").

contrast, managers and board members motivated by profit are less likely to imbue the status quo with moral significance.

At nonprofits, inertia can draw further strength from legal constraints. The nondistribution constraint traps capital,[52] as do restrictions on endowments. "Once nonprofit institutions have been created," Henry Hansmann observed, "they are difficult to control and particularly difficult to get rid of."[53]

To sum up, although the tendency of nonprofits to operate inefficiently is familiar, the literature offers an incomplete explanation. Stakeholders lack not only the incentive, but also the information, to demand better performance. Because nonprofits generate social returns, instead of financial returns, their success is harder to measure. This lack of a clear and widely accepted metric complicates efforts to expose self-interested behavior, root out incompetence, resolve conflict, and overcome inertia.

5. *Stakeholder Capitalism Makes it Harder to Measure Success at For-Profit Firms*

In showing that information problems make mismanagement harder to stop, this Part obviously has focused on nonprofits. Yet the same dysfunctions can arise at a for-profit firm, as long as it faces challenges in measuring success. Although profitability is relatively easy to compute, as noted above, proponents of stakeholder capitalism want for-profit firms also to pursue other goals that are harder to track, such as helping employees and their communities.

Unfortunately, when a for-profit firm's goals become more varied and less quantifiable, it faces the same challenges as nonprofits in rooting out mismanagement. Pursuing goals other than profitability can exacerbate conflict (by introducing competing goals) and inertia (by authorizing more rationalizations for the status quo). The need to balance multiple goals gives managers and boards more discretion, which they might abuse with self-interested or incompetent decisions. For example, when for-profit managers need to shut down one of two businesses, as in the example above, a self-interested choice is easier if they are not obliged to keep the more profitable one.[54]

Obviously, a comprehensive analysis of stakeholder capitalism is beyond this Article's scope. Yet one of its downsides is that for-profit firms face greater challenges in measuring success. As a result, they lose their edge over nonprofits in rooting out mismanagement.

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[52] Hansmann, *Economics, supra* note 22, at 66 ("Nonprofit institutions also seem to be inefficiently slow in contracting their scale of operations, or in exiting an industry entirely, when demand for their services contracts."). Nonprofits cannot return capital to donors when its mission fades in importance, but they can contribute to another nonprofit. *Id.* at 66.
[53] *Id*. at 68.
[54] *See supra* Part I.C.1 & 2.

II. WHICH NONPROFIT STAKEHOLDERS CAN MONITOR IMPACT AND COST-EFFECTIVENESS?

The last Part showed that challenges in measuring success afford nonprofit managers discretion to make unwise and self-interested choices.[55] To block these choices, effective monitoring is needed. But who has the necessary motivation and capacity to play this role? Which nonprofit stakeholders have the potential to be the most effective monitors? After analyzing different possibilities, this Part recommends board members, major donors, and rating agencies, while showing that these stakeholders need better information to discharge this responsibility more successfully.

A. The Three I's: Incentives, Influence, and Information

To block self-interested choices and incompetence, monitors must be willing to invest time and effort. They need to learn the details of a nonprofit's work and its managers' choices. To be effective, monitors also must be independent. Someone seeking the good will of managers — for instance, so they will admit a family member to a competitive program — is not well-positioned to question their decisions.

Along with the right incentives, monitors also must have sufficient influence. Even if they invest time and effort to identify where a nonprofit falls short, they can improve the situation only by persuading, pressuring, or replacing the relevant managers. A board member or major donor obviously is more likely to have this sway than a modest donor.

To be effective monitors, stakeholders also require fine-grained information. They have to explore whether programs are accomplishing the relevant goals, and whether lower-cost alternatives would have comparable impact.

To sum up, nonprofit stakeholders can be effective monitors only if they have "the three I's": incentives, influence, and information. This Part considers the potential of four groups to satisfy these criteria: regulators; beneficiaries; board members; donors; and rating agencies.

B. Government Regulators

For a range of reasons, government regulators are not well-positioned to monitor nonprofit managers. When nonprofits need the government to endorse their work, they are less free to test novel ideas and adjust to changing circumstances. Moreover, government officials usually lack the information and authority to provide this sort of substantive oversight when they act as regulators, at least under current law. In making grants, however, government agencies can (and should) wield the same sort of influence as other major donors.

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[55] *See* Young, *supra* note 7, at 115 ("In nonprofit sectors especially, there tends to be a large margin for discretionary behavior [by managers]. . . . The relatively indirect and part-time control exerted by constituent groups, the imprecise criteria that such groups can apply, and the separation of resource acquisition from resource allocation are the main reasons for this discretion.").

1. Incentives

When they make grants, government officials have reason to dig into the details of a nonprofit's work. But otherwise, government officials do not have the same incentives as other stakeholders to scrutinize a nonprofit's mission and programs. Unlike beneficiaries, regulators obviously do not use the nonprofit's goods and services. Unlike board members, they do not make a choice to volunteer time and associate their reputation with a specific nonprofit. Unlike donors, they do not commit their own money. Without this sort of personal stake, government regulators will not necessarily invest the time and effort needed to dig into the details.

Just as government regulators are too "hands off" in some cases, they are too "hands on" in others. Because regulators usually represent the preferences of median voters and powerful interest groups, they sometimes have political reasons to block a nonprofit from incubating an innovative but controversial idea. Indeed, this used to be a serious concern. Years ago, in deciding whether to approve new nonprofits, state regulators and judges discriminated against "foreigners, cultural diversity, controversial causes, persons of low income and labor unions, and persons of color,"[56] as Professors Fishman, Schwartz, and Mayer have observed.

Fortunately, regulatory review has become more ministerial than substantive under current law,[57] allowing nonprofits to engage in bold experiments. "Unlike government, an independent sector group need not ascertain that its idea or philosophy is supported by some large constituency . . . ," John Gardner has observed. "If a handful of people want to back a new idea, they need seek no larger consensus."[58] This immunity from political constraints is the reason why civil rights, women's rights, environmentalism, and other transformative social movements in the U.S. began in nonprofits; the government did not embrace them until much later, when they enjoyed broader support.[59]

In addition to undercutting a nonprofit's ability to experiment with unconventional ideas, substantive regulatory oversight has other costs as well. If nonprofits need the government to "sign off," political and bureaucratic barriers become more formidable in launching and shutting down initiatives, as well as in making course corrections.[60]

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[56] James J. Fishman, Stephen Schwarz & Lloyd Hitoshi Mayer, Nonprofit Organizations Cases and Materials 55-56 (5th ed. 2015).

[57] *Id.*

[58] John W. Gardner, The Independent Sector *in* American Voluntary Spirit xiii (Brian O'Connell ed. 1983); *see also* Burton A. Weisbrod, *Toward a Theory of the Voluntary Nonprofit Sector in a Three Sector Economy*, in The Economics of Nonprofit Institutions 21, 30-31 (Susan Rose-Ackerman ed., 1986) (defending charitable deduction as empowering minorities to pursue public goals that majoritarian political processes would not endorse).

[59] David M. Schizer, *Subsidizing Charitable Contributions*: *Incentives, Information, and the Private Pursuit of Public Goals,* 62 Tax L. Rev. 221, 244 (2008-2009) ("[A] number of important social movements-from civil rights and women's rights to environmentalism-were pursued first through nonprofits (for example, the NAACP, the ACLU Women's Rights Project, the NRDC) before they ultimately became the subject of government action.").

[60] *See* Hansmann *Economic Theories, supra* note 16, at 35 (nonprofits are less bureaucratic than government); John Tyler, Transparency in Philanthropy 33 (2013) ("there is inherent value in the sector being independent of government and having the flexibility to respond quickly to unexpected needs and opportunities").

In some contexts, substantive oversight from the government — whether in the form of regulation or grant-making – compromises important values. For instance, government officials should not make substantive judgments about the social value of religious institutions. The same is true of newspapers, since the press is supposed to monitor (and criticize) the government.[61] Another key function of nonprofits — competing with the government[62] — can also become more difficult.

2. *Information*

Even if preserving nonprofit independence were not an issue, government regulators would not be well positioned to oversee the missions and programs of nonprofits for another reason: they lack the relevant expertise and information, at least in the office of the state attorney general ("AG") and the IRS, which currently are the agencies most involved in regulating nonprofits. The scope of the U.S. nonprofit sector's work is panoramic — from medicine to art, religion, education, social services, disaster relief, human rights, and more. State AGs and the IRS are unlikely to have "in-house" expertise on even a fraction of this work.

In principle, other regulators could step in. Indeed, some nonprofits are already subject to licensing requirements, periodic recertification, or other substantive oversight by a range of government agencies.

Yet extending this sort of oversight to more nonprofits would pose a range of challenges. For example, coordination among different potential regulators could be daunting. In addition, although government experts might well be knowledgeable about social problems — and thus could assess whether a nonprofit is targeting an important issue — they are unlikely to know about a specific nonprofit's strategy or programs. For example, civil servants at the U.S. Department of Health and Human Services presumably know a great deal about poverty and homelessness, but very little about the work of specific soup kitchens. To monitor the impact and cost-effectiveness of these facilities, they would need access to detailed information about their operations. Even if regulators receive this information, they might not use it effectively; after all, some government agencies do not conduct adequate evaluations of *their own* work. They are unlikely to do better in assessing nonprofits.[63]

3. *Influence*

In addition to lacking the necessary incentives and information to monitor nonprofit managers, government officials also lack the influence to play this role under current law (except in making grants). The main regulators of nonprofits — the state AG, courts, and the I.R.S. —

[61] *See generally* David M. Schizer, *Subsidizing the Press*, 3 J. Legal Anal. 1 (2011).
[62] Brian Galle, *The Role of Charity in a Federal System*, 53 Wm. & Mary L. Rev. 777 (2012) (arguing that charities compete with the government, and are especially useful when state and local governments cannot take on the job).
[63] I thank Louis Kaplow for this point.

generally do not make judgments about the social value of nonprofit initiatives. Any effort to task these (or other) regulators with this function would require changes in the law.[64]

a. State Attorneys General and Courts

The main regulators of nonprofits are state AGs.[65] In principle, they have significant power, but in practice their resources are limited.[66] They focus on misconduct, as well as on abusive fundraising practices, but not on the impact and cost-effectiveness of programs. They lack the expertise, information, and objectivity to provide substantive oversight.[67]

Courts face similar limitations. While they know how to police misconduct and enforce duties of loyalty — for instance, by deciding cases about undisclosed conflicts and embezzled funds — courts lack the expertise and information to evaluate a nonprofit's work.[68] Issues of impact and cost-effectiveness are seldom litigated, if only because standing rules do not permit donors and beneficiaries to bring derivative lawsuits.[69] Therefore, courts and state attorneys general do not provide meaningful substantive oversight of charities.

b. Tax Subsidies That Preserve Nonprofit Independence

Likewise, the I.R.S. is quite "hands off" in administering the tax system's two main charitable subsidies: the deduction for donations[70] and the tax exemption for a charity's income.[71] These subsidies do not depend on the I.R.S. to make judgments about which charities

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64 *See* Tyler, *supra* note 60, at 38 (" neither charity officials nor the IRS have the legal authority or legitimate right to substitute their personal opinions, preferences, or judgment for that of the donor or of foundation personnel, if such judgment is exercised reasonably and in good faith and otherwise satisfies donor intent and complies with the law").

65 Manne, *supra* note 11, at 228 ("nonprofits are loosely overseen by . . . the attorneys general of the fifty states").

66 Mary Grace Blasko et al., *Standing to Sue in the Charitable Sector*, 28 U.S.F.L. Rev. 37, 39 (1993) ("Lack of money, coupled with the obligation to discharge the other important duties of the attorney general's office, contributes to inadequate staffing for the purpose of supervising charities. This often results in a necessarily selective prosecution of only the most egregious of abuses.").

67 Manne, *supra* note 11, at 227 ("The attorney general's office is often understaffed and underfunded. . . . It is also a highly political office, and the government's agenda with respect to enforcement of charitable obligations is unlikely to include detached matters of efficiency, and may reflect a political ideology inimical to the aims of certain nonprofits.").

68 *Cf.* Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation,* 55 Duke L. Rev. 711, 750 (2006) ("courts are ill-suited to handle breaches of the duty of care, as identifying mismanagement requires second guessing managements' business decisions").

69 Hansmann, *Economic Theories*, *supra* note 16, at 32; Manne, *supra* note 11, at 238 ("To the detriment of nonprofits, standing rules have essentially undermined the effectiveness of default fiduciary rules as they apply to the nonprofit sector.").

70 The charitable deduction generally allows donors to avoid paying tax on amounts they give to charity. *See* I.R.C. § 170. For example, if a taxpayer earns $1 million of salary and contributes $100,000 to charity, she pays tax on only $900,000. If her marginal tax rate is 37%, this contribution of $100,000 reduces her tax by $37,000.

71 The exclusion spares charities from paying tax on their income from operations and from passive investments. *See* I.R.C. §501(a) (excluding the income of I.R.C. §501(c)(3) organizations from tax). For example, a charity that

to subsidize; instead, they provide billions of dollars automatically, as long as charities satisfy very general criteria.[72]

Each subsidy is available to charities qualifying under I.R.C. § 501(c)(3) as "organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes."[73] To confirm their eligibility, charities can seek a letter from the I.R.S. by sharing their bylaws and articles of incorporation, and also describing their mission, projected budget, and sources of funding. Although some applications are denied, the government is not supposed to assess the merits of the cause or the charity's competence to advance it.

Once charities satisfy these very general requirements, the deduction and exemption are automatically available, as long as private individuals take the relevant steps. For the deduction, this step is a contribution to charity.[74] For the exemption, by contrast, the subsidy is triggered when a charity earns income.[75] In each of these subsidies, government officials have no discretion to adjust the size of the subsidy, regardless of their view of a charity's work.[76]

c. Government Agencies as Donors

In contrast, the government has considerable discretion in making grants, which are quite sizable in some fields. Like other donors, government agencies evaluate the merits of specific nonprofit programs, and often seek detailed reports, set benchmarks, and impose conditions. Government grants are a significant source of income for some nonprofits,[77] and a government grant also can be a positive signal, which induces others to contribute. As a result, government donors can have significant influence, as well as the incentive and expertise to monitor

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earns $100,000 of interest on bonds does not pay tax, thereby avoiding the 21% corporate tax that otherwise would apply.

[72] As noted above, in describing the exemption as a subsidy, this Article assumes that the baseline regime is an income tax, and that taxpayers otherwise would be taxed on resources they give away. *Compare* William D. Andrews, *Personal Deductions and the Ideal. Income Tax*. 86 Harv. L. Rev. 309 (1972) (money a taxpayer gives away should not be considered her income) *with* Mark Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an "Ideal" Income Tax and Why They Fit Worse in a Far From Ideal World*, 31 Stan. L. Rev. 831 (1979) (giving money away is something a taxpayer chooses to do, so this money should be considered her income).

[73] I.R.C. §501(c)(3). I.R.C. §501(c)(3) lists a few other permissible purposes as well, and also requires nonprofits to use the right kind of legal entity, avoid certain types of political activity, and ensure that their net earnings do not "inur[e] to the benefit of any private shareholder or individual." *Id.* In general, the deduction is available only for contributions to organizations that qualify under I.R.C. §501(c)(3), but the exemption is available also to social welfare organizations that engage in lobbying, labor unions, and trade associations. *See* I.R.C. §501(c)(4) & (5).

[74] I.R.C. §170.

[75] Charities pay no tax on revenue from their mission or from passive investments. For a discussion of which aspects of this tax exemption should be considered a subsidy, see Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*,85 Yale L. J. 299, 311, 315 (1976).

[76] Since charitable contributions reduce a donor's taxable income, and thus her tax bill, the subsidy rate is based on the donor's marginal tax rate. Since a nonprofit's revenue is not taxed, the subsidy is the marginal rate that otherwise would apply to the charity (the 21% corporate tax rate).

[77] Government grants represented 8% of public charities' revenue in 2013, and government fees represented another 24.5%. Brice S. McKeever, The Nonprofit Sector in Brief 2015 (2015), http://www.urban.org/sites/default/files/alfresco/publication-pdfs/2000497-The-Nonprofit-Sector-in-Brief-2015-Public-Charities-Giving-and-Volunteering.pdf [https://perma.cc/YEZ8-2NDD].

management. Yet in making grants, the government obviously is functioning as a donor, rather than as a regulator; the critical role of donors in monitoring nonprofits is discussed below.[78]

C. Beneficiaries

In general, beneficiaries of a charity have the right incentives to push for impact and cost-effectiveness, and often have the right information as well. But they do not have enough influence unless they fund a meaningful share of a nonprofit's budget. As a result, beneficiaries can monitor management more effectively at "commercial" nonprofits, which are largely funded by beneficiaries, than at "donative" nonprofits, which are mostly funded by donors.[79]

1. Incentives

By definition, a nonprofit's mission is to serve its beneficiaries. As a result, beneficiaries want nonprofits to be efficient. When a nonprofit wastes money, beneficiaries get less value from it. But when a nonprofit figures out how to provide more (or better) goods and services for the same price, beneficiaries reap this reward.

Admittedly, beneficiaries do not always have the right incentives. When nonprofits serve multiple constituencies, each might try to advance its own narrow interests, distracting the nonprofit from higher value efforts to serve other (or, indeed, all) beneficiaries. For example, alumni fans might urge universities to spend on lavish stadiums instead of on research and instruction, even though the latter are more valuable to students and to society as a whole.

2. Information

To be effective, monitors must have not only the right incentives, but also the right information. In this regard, beneficiaries often compare favorably with other stakeholders because they use a nonprofit's goods and services, and thus have first-hand knowledge of its impact. For example, when a disaster relief organization helps earthquake victims, they know more about the aid they receive than donors, who may be thousands of miles away.

Yet beneficiaries cannot always evaluate the quality of a nonprofit's work. They may lack relevant expertise (*e.g.*, to evaluate health care) or cognitive ability (*e.g.*, to evaluate animal shelters).[80] Or they may have no contact with a nonprofit, even though they are part of a diffuse group that benefits from its work, for instance, in basic scientific research, civil rights advocacy, or environmental protection.

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[78] *See infra* Part II.E.

[79] *See* Hansmann, *Economic Theories, supra* note 16, at 28 (distinguishing donative and commercial nonprofits).

[80] Indeed, reassuring beneficiaries who can't judge quality is a key reason to use nonprofits. *See supra* Part I.A.1. *But cf.* Prakash & Gugerty, *supra* note 11 (to be reassured, beneficiaries need to understand that the nonprofit form limits the incentive of nonprofit leaders to overcharge or skimp on quality).

3. Influence

Even if beneficiaries are motivated and knowledgeable, they also need influence to be effective monitors. Will managers listen to them? The answer often turns on how much revenue they supply.

If beneficiaries do not foot much of the bill, they have relatively little leverage. Managers may still choose to listen, motivated by their own professional pride and commitment to the mission. Even so, ignoring this feedback will not jeopardize their budgets or jobs, unless stakeholders with more influence, such as board members and donors, press managers to pay more attention to beneficiaries' views.

The analysis changes, though, if beneficiaries supply a meaningful share of a nonprofit's revenue. This financial clout gives them essentially the same influence as consumers at for-profit firms. Indeed, when beneficiaries have the means to fund a nonprofit's budget, other nonprofits are likely to compete for their business. This product market competition is likely, in and of itself, to enhance impact and cost effectiveness.[81]

Obviously, nonprofits vary significantly in the funding they receive from beneficiaries. At universities, tuition revenue is critical, so universities compete vigorously for students by offering innovative programs, better amenities, and the like. In contrast, soup kitchens and disaster relief organizations derive very little revenue from beneficiaries, so product market competition imposes less discipline on them.

To sum up, beneficiaries usually have the incentive and information to monitor management. The key variable is whether they supply enough funding to have meaningful influence. In general, they have significant clout at commercial nonprofits, but not at donative nonprofits.

D. Boards of Directors

Like beneficiaries, boards of directors also play a role in monitoring management. Yet boards vary in their effectiveness. In general, they are better at monitoring issues that are easy to observe or measure.

1. Incentives

Board members have two main motivations to monitor management, which resonate more with some than with others. First, they usually believe in the nonprofit's mission, and want it to succeed. Second, they have a reputational stake in avoiding problems on their watch.

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[81] Hansmann, Ownership, *supra* note 18, at 239 ("nonprofit firms often appear to be managed with substantial efficiency when, as is often the case, they operate in a competitive environment"); Prakash & Gugerty, *supra* note 11, at 41 ("When customers provide much of the revenue, they can vote with their feet.").

In principle, they also want to avoid liability, but this motive is weak at best. Boards are supposed to act in the organization's best interest, stay informed, and avoid conflicts of interest. Yet enforcement of these fiduciary duties is weaker in nonprofits than in for-profit firms; the state AG can bring a lawsuit, but donors and beneficiaries generally lack standing to sue.[82] As a result, if directors are like Justice Holmes' "bad man" in doing only the minimum to avoid liability, they need to block egregious managerial behavior, but can settle for mediocrity.

As a result, much depends on the personal commitment and abilities of board members. To keep managers from making unwise and self-interested choices, boards need to dig into the details, vetting the impact and cost-effectiveness of programs. How willing are they to do so?

Unfortunately, some nonprofit board members are less capable and committed than others. As volunteers, many invest only limited time.[83] Some are there for self-interested reasons. They value the prestige of board service and like to form social ties with influential people.[84] They may also want special access to the nonprofit's services (*e.g.,* the best doctors at hospitals).

Board members with these motives are unlikely to ask hard questions. Someone looking for friendships and pleasant experiences usually steers clear of uncomfortable situations. Likewise, someone seeking a leadership role does not want to "rock the boat," and someone wanting special access to a nonprofit's services can't afford to antagonize managers.

Board members sometimes pursue other personal agendas as well. If they befriend a manager, they might advocate for their friend's career and program. Conversely, if they dislike a manager, they might undercut her and her program for non-merits-based reasons. In addition, if they donate to a specific project, they might use their influence as board members to advance this initiative.[85]

In pursuing personal agendas, board members sometimes clash with each other. Unfortunately, these conflicts can delay key decisions, consume the attention of the organization's leaders, and interfere with fundraising.

2. Information

To monitor managers effectively, nonprofit boards must have not only the right incentives, but also the necessary information. As volunteers, they know less about day-to-day operations than management, but have ample authority to ask for information.

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[82] Brody, *Agents Without Principals, supra* note 16, at 466.

[83] Young, *supra* note 7, at 155.

[84] Melissa Middleton, *Nonprofit Boards of Directors: Beyond the Governance Function*, in The Nonprofit Sector: A Research Handbook (Walter W Powell ed. 1987) (first edition) at 141, 149-51 ("[B]oard members are part-time volunteers who may serve as trustees for a variety of noneconomic reasons, such as the desire to become more fully integrated into the community, to develop new circles of friends, and to gain status and prestige."); Hansmann, *Economic Theories, supra* note 16, at 36 (donating to performing arts can confer membership in prestigious club).

[85] Triantis, *supra* note 11*,* at 1148 (since donors have different philanthropic objectives, a board member's interests are likely to diverge from those of other donors).

In requesting information, most boards focus on their nonprofit's solvency, internal controls, and compensation, rather than on the details of its work. Boards typically review audited financials, insurance coverage, investment reports, management compensation,[86] and policies to prevent misconduct.[87] Yet as Francie Ostrower has observed, "[w]e have to ask not only whether nonprofit boards have various practices and policies in place to avoid malfeasance, but whether they are . . . ensuring that the organization is accomplishing its mission."[88] Based on a survey of over 5,000 nonprofits, she concludes that boards are much less likely to monitor the substance of a nonprofit's work.[89]

This focus on solvency and governance, instead of on programs and grants, reflects the skill sets of most nonprofit board members. Arguably, nonprofit boards should include more members with expertise in the mission. Yet boards often are composed of investment bankers, lawyers, and entrepreneurs, who are chosen in part for their philanthropic capacity. These board members often have deep experience reviewing financial statements, updating governance policies, and setting pay, but not in analyzing the nuances of disaster relief, performing arts, social services, or academic research.[90] At most nonprofits, boards are self-perpetuating. In choosing successors, board members often gravitate toward candidates with similar professional experience, replicating their own strengths and weaknesses.

Like nonprofits, for-profit firms sometimes also have directors who are not experts in the firm's work. Yet these generalists can use a short-cut to monitor management – tracking earnings – that is unavailable at nonprofits, as emphasized above. For example, if an investment banker joins the board of an energy company, and is not an expert on energy, she can focus on whether the company is profitable. If it is losing money, she knows to ask probing questions. In contrast, if the same investment banker joins the board of a humanitarian organization, she cannot look at its earnings to check whether it is succeeding; instead, she has to dig into the details of its work, as noted above.

To develop this granular understanding, boards should ask managers to educate them about the nonprofit's work. They also should seek feedback from beneficiaries. In addition, they also can consult independent experts, for instance, about which metrics to track, as well as about whether the nonprofit's programs, fundraising, and governance are state of the art.

3. Influence

To monitor management, boards must have not only motivation and information, but also influence. In general, boards have three key sources of authority. First, they choose (and fire) the CEO. Second, they usually sign off on the budget. Since almost anything a nonprofit does must appear in its budget, boards can use their sway over budgets to influence almost any aspect of a

[86] Francie Ostrower, Nonprofit Governance in the United States: Findings on Performance and Accountability from the First National Representative Study 2 (2007) [hereinafter "Nonprofit Governance"].
[87] *Id.* at 4.
[88] *Id.* at 1.
[89] *Id.* at 12 ("substantial percentages of nonprofits report that their boards are not actively engaged in basic stewardship responsibilities").
[90] Brody, *Agents Without Principals, supra* note 16, at 467-468.

nonprofit's work. Third, as noted above, boards usually choose who serves on the board, allowing them to remain in place or to pick their successors. In principle, these formal powers give board members ample influence over managers.

Yet in practice, the board's influence varies on two dimensions. First, some nonprofit boards are more active than others. Some are quite "hands on" about details, while others are very deferential to management. Meeting agendas, the frequency of meetings, and the time and effort invested by the board all vary dramatically. Second, within each board, some members have more influence than others. For example, some chairs have effective control, while others are "first among equals." Likewise, some board members gain extra clout through especially large donations, while others do so through close personal ties with managers and other board members.

To sum up, all board members have formal authority to monitor management, but they vary in their motivation and capacity to do so. In general, they focus on what they can easily observe and understand, such as CEO pay and conflict of interest policies. Unfortunately, they focus less on the impact and cost-effectiveness of programs. While some board members make this effort, others shy away from difficult decisions and focus on personal agendas. In other words, some board members are a *solution* to agency costs, while others are *part of the problem*.

E. Donors

Like boards of directors, major donors often have the incentive and influence to monitor management. A key question is whether they have the right information.

1. Incentives

Donors usually give money because they are committed to the cause,[91] but this commitment can manifest itself in different ways. For some donors, good intentions are enough, and they do not need to verify that their funds are put to good use.[92] At some level, they may even prefer not to know this hard truth, which would erode their feelings of satisfaction.[93] These donors obviously are less motivated to police managerial agency costs and incompetence.

In contrast, other donors are very focused on impact. Wanting to get the most for their money, they look for evidence that their gift is making a difference. This quest for results is a familiar philanthropic trend, which is especially common among professionally managed

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[91] In some cases, donors have other motivations (*e.g.,* a favor to a friend, a way to burnish their image, *etc.*).

[92] *See* Kumar, *supra* note 9, at 3-4 ("The global aid industry has long operated with an underlying assumption that the most important thing is to have good intentions. For as long as people have been giving money and help to strangers, after all, they have felt driven by the intention to do good and, often, to take credit for it.").

[93] I thank Louis Kaplow for this point.

foundations and younger donors.[94] These donors are motivated to serve as monitors, at least when they give major gifts.[95]

The literature has not focused sufficiently on the motives of these donors, assuming instead that stakeholders who cannot share in surpluses do not press for efficiency.[96] Yet donors still benefit from efficiency in two ways. First, their gift has greater impact, and thus is more satisfying. Second, instead of giving a fixed amount, some donors fund a specific need, and thus can give less when a nonprofit addresses it at a lower cost; this savings is the functional equivalent of a distribution.[97]

Despite these reasons to press for efficiency, donors do not always do so — and, indeed, are sometimes a *source* of inefficiency — for a range of reasons. First, their support comes at a cost. Nonprofits must invest in fundraising, just as for-profit firms spend on marketing. Although these expenditures are necessary, diverting resources from the mission is never wholly satisfying.

Second, in deciding what to support and how to use their influence, some donors are swayed by personal relationships. Like board members, they might befriend (or dislike) specific managers, and defend (or undercut) them and their programs for non-merits-based reasons.

Third, even when donors focus on the merits, they sometimes champion the wrong cause (just as managers sometimes do). For some, good intentions are enough, as noted above. For others, the results matter, but these donors do not take the time to make fully informed judgments, especially in making modest contributions.[98] In addition, some donors have idiosyncratic preferences, and fund causes that others find unappealing or even offensive. After all, a key purpose of nonprofits, emphasized above, is to experiment with new ideas, which may well be controversial. Some ideas prove themselves over time, while others do not.

Fourth, even when donors support worthwhile causes, they sometimes choose the wrong strategies and programs. After all, donors often lack expertise about the mission.[99] They sometimes receive helpful guidance from philanthropic advisors or other experts. Nonprofit managers can also be a valuable resource, at least if donors trust them. But managers are not

94 *See* Gugerty & Karlan, *supra* note 8, at 8 ("[P]hilanthropic culture has changed ... young and wealthy philanthropists are different from their parents and grandparents; they want to make sure their dollars are having a measurable impact."); Kumar, *supra* note 9, at 4 ("In the new aid industry, giving is increasingly being evaluated not by the goodness of the intentions or the amount of money given but rather by results.").

95 Triantis, *supra* note 11, at 1148 ("donors with small stakes are likely to exhibit the same passivity as their counterparts in commercial corporations").

96 Hansmann, *Nonprofit Enterprise, supra* note 7, at 878.

97 To illustrate these two (related) donor motivations, consider two donors who support financial aid at a school. Anne gives $50,000, regardless of what the tuition is. If Anne pushes the school to run more efficiently, she does not save money, but her gift helps more students and thus is more satisfying. In contrast, Betty commits to pay the tuition of one student. If efficiencies reduce tuition from $40,000 to $35,000, Betty saves $5,000.

98 Hope Consulting, Money for Good 27 (2015), http://www.cambercollective.com/moneyforgood [https://perma.cc/9NL9-ZNAP] (38% of surveyed donors researched at least one donation, 33% researched performance, and 9% compared two nonprofits).

99 *See* Prakash & Gugerty, *supra* note 11, at 25 (noting that donors often lack expertise to monitor nonprofits).

always willing or able to steer donors in the most productive direction (and, indeed, make the wrong choices themselves sometimes, as noted above).

Fifth, even when donors choose the right strategy, they do not always push hard enough for it. Instead of pressing managers to improve, the easier course often is to look for a different nonprofit to support. For example, in suggesting improvements in a program, a donor sometimes encounters resistance from managers, who have self-interested reasons to favor the status quo. Other donors may push back as well, not wanting to acknowledge flaws in a program they have supported for years. When facing this sort of resistance, a donor cannot invoke the warning signs that justify change at for-profit firms: declining earnings or share price. Instead of continuing to press the issue, a donor may decide instead to find a different cause.

Sixth, pride and ego complicate some donor choices. For example, some donors want to fund only *new* initiatives, considering this the best way to make their mark. Admittedly, a gift can seem especially impactful in helping a nonprofit do something new, but a key question is why the nonprofit is not *already* doing it. If the reason is that conditions have changed, and the new initiative is a necessary response, then funding it is worthwhile. But another explanation is that managers do not consider the initiative a priority. If their assessment is correct, funding it is a misallocation of resources.

Finally, some donors are themselves organizations, which have agency costs of their own. At private foundations, managers sometimes prioritize their own preferences over those of their principal. Similar dynamics can influence federated funds, such as the United Way and Jewish Federations. The nonprofit equivalent of mutual funds, these public charities collect donations and allocate them to other charities, which run the relevant programs. Their grant-making is supposed to focus on the merits — and, indeed, is often the product of extensive deliberations by professionals and volunteers. But sometimes their priorities shift for non-merits-based reasons (*e.g.,* to reflect the interests of new lay and professional leaders or to enhance fundraising by focusing on trendy needs). Likewise, their allocations sometimes reflect political dynamics, for instance, in deferring to influential stakeholders.

2. Information

Along with the right motivation, donors also need the right information. To ensure that the programs they fund are impactful and cost-effective, while also confirming that a nonprofit's work aligns with their preferences, donors need to dig into the details. Yet the relevant information can be hard to acquire.

Donors often do not have first-hand knowledge of a nonprofit's work, since they usually fund goods and services for beneficiaries they never meet. Admittedly, some donors are themselves beneficiaries (or former beneficiaries), for instance, in supporting their alma mater, local religious and cultural institutions, and hospitals. Some donors also learn about a nonprofit's work as volunteers. But many donors have little personal contact with programs they fund.[100] Their main source of information is the nonprofit's management, who have an obvious conflict of interest. Admittedly, investors in a for-profit firm face similar challenges. But again, these investors can rely on profitability to measure success, while nonprofit donors cannot.

Even when donors have a clear picture of a nonprofit's overall activities, they rarely know the marginal impact of their contribution.[101] Donors make decisions in isolation, without knowing what others fund.[102] Since money is fungible, each donor has only limited influence on a nonprofit's budget.[103] For example, a university donor might designate her gift to financial aid, hoping to increase the financial aid budget. But fundraisers can respond by steering other donors away from financial aid, so total expenditures on financial aid do not change. The broader the nonprofit's portfolio of programs, the easier it is for managers to maintain their discretion in this way, even as donors make targeted gifts.

Although no donor has complete information, some have more than others. Compared with modest donors, major donors have leverage to ask for details. In gift agreements, they can require reports on how their gift was spent, as well as on its impact. The agreement also can set benchmarks, such as the number of clients that must be served. This has become a common practice for private foundations, and is increasingly common for wealthy individual donors and government agencies as well.

Yet although this sort of report is helpful, it is still likely to have gaps. Donors do not necessarily ask the right questions or suggest the right benchmarks, since they are not immersed in the nonprofit's operations.[104] In addition, a report prepared for only one donor may not convey the full picture, and may even be inconsistent with reports prepared for other donors.

Instead of a tailored report, modest donors usually have to rely on publicly available information, which can be uneven. A nonprofit's website and marketing materials typically offer

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[100] *See* Young, *supra* note 7, at 111 ("One important source of relief, and hence discretion, for nonprofit entrepreneurs is that few constituents will have direct knowledge of performance, much time for monitoring, or precise criteria for judgment."); Hansmann, *Economic Theories, supra* note 16, at 30 ("The difficulty is that the purchaser (donor), who has no contact with the intended beneficiaries, has little or no ability to determine whether the firm performs the service at all, much less whether the firm performs it well.").

[101] Ellman, *supra* note 20, at 1010.

[102] *See* Saul Levmore, *Taxes as Ballots*, 65 U. Chi. L. Rev. 387, 411 (1998) ("a donor's decision as to how to allocate his own funds . . . depends on other contributors' decisions").

[103] *Cf.* Young, *supra* note 7, at 111-12 (noting that decisions about programs are separate from resource allocation, leaving nonprofit entrepreneurs with substantial discretion).

[104] *Cf.* Jennifer Alexander, Jeffrey L. Brudney & Kaifeng Yang, *Introduction to the Symposium: Accountability and Performance Measurement: The Evolving Role of Nonprofits in the Hollow State*, 39 Nonprofits & Vol. Sect. Q. 565, 566 (2010) ("funders and nonprofit executives indicated that they do not always fully understand what they are asked to measure or how to make sense of the results. Practitioners and academics concurred that a great deal of data is generated for symbolic purposes and that the interpretation can be highly ambiguous").

general descriptions of their mission, compelling images, and inspiring anecdotes.[105] But data and analysis on the mission and programs are harder to find.

Donors can read Form 990, the nonprofit's annual tax return, on a website called "GuideStar" that shares information about thousands of nonprofits. Yet Form 990 is of limited value under current law. It often includes errors[106] and is out-of-date.[107] Form 990 also offers very little information on a nonprofit's mission and programs.[108] It includes a financial statement, which classifies how much is spent on programs, as opposed to administration and fundraising. Yet nonprofits are not asked to explain how they measure success, or to offer details on the impact or cost-effectiveness of their programs.[109]

Instead, Form 990 focuses on governance, solvency, and compliance with tax rules. For example, it describes the nonprofit's internal controls and lists the names and pay of board members and senior managers, enabling the I.R.S. to confirm that the organization is not distributing profits to its leaders. Form 990 also offers information about two types of activities, lobbying and for-profit businesses, which are subject to special tax rules.[110]

In addition to Form 990, modest donors can seek information from the media. The press often covers problems targeted by nonprofits, such as natural disasters, pandemics, and failing

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[105] *See* Gugerty & Karlan, *supra* note 88, at 6 ("Often, organizations trying to produce social impact have marketed their work to donors through stories about specific individuals who benefited from their programs.").

[106] Evelyn Brody, *Sunshine and Shadows on Charity Governance: Public Disclosure as a Regulatory Tool*, 12 Fla. Tax Rev. 183, 184 (2012) (observing that many Form 990s "contain errors, some materially misleading") [hereinafter Brody, "*Sunshine*"]; Karen A. Froelich & Terry W. Knoepfle, *Internal Revenue Service 990 data: Fact or Fiction?*, 25 Nonprofit & Vol. Sect. Q., 40, 42 (1996) ("problems with this source of data are increasingly being recognized").

[107] Since the filing deadline is over ten months after the end of their tax year, information about a given year (*e.g.,* 2020) is not available until November 15 of the following year (*e.g.,* 2021). This assumes nonprofits are on a calendar tax year and claim an automatic six-month extension.

[108] The closest Form 990 comes to these issues is in Part III, a "statement of program service accomplishments," which is supposed to describe the mission and give an overview of accomplishments and expenses in the nonprofit's three largest program areas. The focus is supposed to be changes since the prior year. *See* Instructions for Form 990 Return of Organization Exempt From Income Tax (2019), Part III, https://www.irs.gov/instructions/i990#idm140401897078624 [https://perma.cc/3YFE-UYCF].

[109] Peter Swords, *The Form 990 as an Accountability Tool for 501(c)(3) Nonprofits,* 57 Tax Lawyer 571, 517 (1998) (noting that Form 990 is potentially effective in preventing self-dealing, an effort he calls "negative accountability," but it is not effective at determining "whether an organization is doing anything useful or whether it is doing it effectively," which he calls "positive accountability"); Brody, *Sunshine, supra* note 106, at 188 ("Regrettably, the most important information that both regulators and the public might want will continue to be unavailable. . . As a society, we would want to be able to assess whether and which charities are producing favorable outcomes, but often we cannot even measure outputs because quality can be subjective. . . . Thus, beyond the scope of this paper is the ultimate disclosure question: How do we challenge an organization that says it 'does good'?").

[110] Certain types of nonprofits are required also to provide special disclosure. For example, hospitals must release a community health needs assessment every three years. *See* Treas. Reg. 1.501(r) -- 3(b)(1)(iv). Likewise, nonprofits engaged in public interest litigation are required to disclose "a description of cases litigated and the rationale for the determination that they would benefit the public generally." *See* section 3.04 of https://www.irs.gov/pub/irs-tege/rp1992-59.pdf.

schools. Scandals at nonprofits also are likely to be covered.[111] Supplementing this piecemeal reporting, outlets that focus on the nonprofit sector, or on areas within it such as international development, provide more sustained coverage.[112] Even so, the media rarely analyzes the impact and cost-effectiveness of specific programs.

Donors also can investigate whether nonprofits have received a "seal of approval" from an industry association by committing to meet its standards. Yet as with rating agencies, these associations usually focus more on governance practices than on the quality of programs.[113]

Given these limits on publicly-available information, some modest donors rely on intermediaries to allocate their donations, such as the United Way or Jewish Federations. These federated funds have the clout to ask for information but, as noted above, their allocations are sometimes skewed by their own agency costs and other internal dynamics.

3. Influence

Even if donors have the incentive and information to press for more efficient resource allocation, they do not always have the influence to do so. The key variable is how much they give. Unlike modest donors, major donors have significant sway with management.[114] If the nonprofit does not meet their expectations, these donors can find other outlets for their philanthropy, and this prospect gives them leverage. Some donors exert added influence by inducing others to give. For example, a gift from well-respected donors can serve as a "seal of approval" for others.

Current and future donations carry more influence than past donations. For example, a donor who gave an endowment last year can no longer withhold her support, and thus has less clout than one who retains discretion to stop giving.[115] This is all the more true of someone who endowed a private foundation, and has since passed away; in this circumstance, foundations often implement the preferences of their professionals and board, rather than of their founder. Anticipating this erosion of influence, endowment donors often require the endowment to be returned (or given to another charity) in specified circumstances. But these contractual restrictions are an imperfect source of influence, since donors cannot anticipate all the scenarios they wish to prevent.

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[111] *See* Swords, *supra* note 109, at 573 ("Good reporters -- hard-news, hard-news reporters -- love nothing more than exposing such abuses.").
[112] *See, e.g.,* https://www.devex.com/news [https://perma.cc/GJ3L-9U95] (covering international aid industry); https://ejewishphilanthropy.com/ [https://perma.cc/SV7X-YNU8] (covering Jewish philanthropy).
[113] *See* Prakash & Gugerty, *supra* note 11, at 34-35 (advocating "accountability clubs" as signals of quality and offering examples of club standards on board composition, HR management, fundraising practices, and transparency).
[114] Hansmann, *Economic Theories, supra* note 16, at 31-32. At first blush, the influence of donors *as a group* might seem limited, since donations *on average* are less than a third of U.S. nonprofits' revenue. *See* Brody, *Agents Without Principals, supra* note 16*,* at 470 ("few nonprofits actually rely on donors for the bulk of their support.") Yet some (*e.g.,* social services organizations) rely much more on donations than others (*e.g.*, hospitals). Even when donations fund only a fraction of the budget, managers still don't want to lose them, or they will have to make painful cuts in services and employee headcounts.
[115] Schizer, *Comparing the Deduction With the Exemption*, *supra* note 4, at 665.

To sum up, many donors want their money to be used wisely, but only a subset give generously enough to exert meaningful influence. Like board members, major donors have the motivation and clout to monitor management, but they do not always have this information. One way to improve the monitoring of nonprofit managers, then, is to provide major donors with the information they need.

F. Rating Agencies

In principle, a promising source of information and analysis for donors is rating agencies. The mission of these institutions is to analyze philanthropic opportunities. Like major donors, they usually have the right incentives, as well as the potential to exert significant influence. Yet as with major donors, a key question is whether they have the necessary information.

1. Incentives

The job of these rating agencies is to evaluate nonprofits. To attract readers (and revenue), rating agencies need to dig into the details of missions, budgets, and programs, identifying which nonprofits offer the most "bang for the buck." To deploy the relevant expertise, agencies should either hire a broad range of experts or specialize in particular types of nonprofits (*e.g.,* so one focuses on hospitals, another on social services, still another on the arts, *etc.*).

In mobilizing this expertise, rating agencies offer economies of scale. Individual donors can avoid the duplicative effort of conducting their own assessments, depending instead on a rating agency to amortize the costs of its analysis across all of its readers.

Needless to say, rating agencies can play this role only if they attract the necessary funding. In principle, donors should be willing to pay for this service – for instance, by subscribing to a website with restricted access – so they can find better philanthropic opportunities. But if donors can access evaluations without paying, they will be tempted to "free ride." To offset this loss of revenue, rating agencies can organize as nonprofits and seek donations. Foundations and other donors that value rigorous analysis should support this work, recognizing that better monitoring should enhance the nonprofit sector's impact and cost-effectiveness.

Even so, a familiar concern about all gatekeepers applies here as well: who is monitoring the monitor?[116] Is the rating agency going the extra mile? Is it developing a nuanced understanding of a nonprofit's impact and cost-effectiveness? Competition with other rating agencies should motivate it to do so.

Is the rating agency even-handed? Its objectivity could be compromised, for example, if it charges nonprofits for evaluations or other services. By analogy, commentators worry about conflicts of interest facing proxy advisors. These firms evaluate (for-profit) public companies,

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[116] *See generally* John C. Coffee, Jr., Gatekeepers (2006).

advising shareholders how to vote on proxy proposals. But these firms also sell consulting services to companies they monitor, prompting commentators to worry about quid pro quos, in which companies essentially pay to receive positive evaluations.[117]

To avoid this sort of conflict of interest, rating agencies should not take money from nonprofits they evaluate. Instead, they should rely on subscription revenue and donations, as noted above. Admittedly, major donors to a rating agency might try to advocate for nonprofits they support. But rating agencies need to rebuff this lobbying – something donors should understand – to ensure that ratings are unbiased.

2. Information

To monitor nonprofit managers, rating agencies need not only the right incentives, but also the necessary information. Yet unfortunately, most rely on Form 990, which says very little about nonprofit programs, as noted above.

As a result, most rating agencies do not analyze a nonprofit's work. For example, Charity Navigator assesses a nonprofit's "financial health" and "accountability and transparency," but does not evaluate programs.[118] Similarly, Global Giving vets nonprofits every two years for "transparen[cy]," accountab[ility]," and legal compliance, but not for "effectiveness."[119]

Given the limited information available on Form 990, rating agencies often focus on a number that is easy to compute with the information it provides: the percentage of the budget allocated to administration, as opposed to programs.[120] Yet these overhead ratios are "deeply flawed as a measure of implementation quality," Mary Kay Gugerty and Dean Kalman have observed. "Some things simply cost more to administer than others."[121] In addition, some types of overhead actually are evidence of quality. For example, donors depend on nonprofits to

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117 *See* Timothy Doyle, *The Conflicted Role of Proxy Advisors,* Harv. Law School Forum on Corporate Governance Blog, (May 22, 2018), https://corpgov.law.harvard.edu/2018/05/22/the-conflicted-role-of-proxy-advisors/ [https://perma.cc/UQ33-PUPW] ("proxy advisory firms are incentivized to align with the comments of those who pay them the most and to move targets and change policy to create a better market for their company-side consulting services")

118 Specifically, Charity Navigator awards between one and three stars based on two factors. First, "financial health" reflects access to working capital, growth in the program budget, and spending on administration and fundraising. Second, "accountability and transparency" evaluates governance practices, such as whether the charity has an independent board and audited financials. *See* Charity Navigator, *Charity Navigator's Methodology*, https://www.charitynavigator.org/index.cfm?bay=content.view&cpid=5593&from=short-url#rating [https://perma.cc/97Z6-TVXJ].

119 https://www.globalgiving.org/aboutus/how-it-works/vetting/ [https://perma.cc/7QVX-Z5C6].
("Global giving performs rigorous due diligence . . . to ensure they are performing charitable work in a transparent and accountable manner, and that they meet local requirements for registration with their local government. . . . [O]ur nonprofit partners have the opportunity to share extra information about the effectiveness of their work. Organizations can share information about how they listen to their stakeholders, test out new ideas, and improve their programs and services based on what they learn from data and feedback.")

120 Diana Stork & Jill Woodilla, *Nonprofit Organizations: An introduction to Charity Rating Sources and Cautions in Their Use*, 6 Int'l J. Applied Man. & Tech. 5 (2008) (rating agencies rely predominantly on financial ratios).

121 Gugerty & Kalman, *supra* note 8 at 68.

comply with the law and have effective internal controls, and this internal oversight requires resources. In addition, overhead also includes efforts to set priorities and monitor the effectiveness of programs, and this Article obviously urges nonprofits to invest *more* in this type of overhead.

At best, a rating that focuses on information in Form 990, such as "financial health" and "accountability and transparency," is "basically a negative screen — it flags organizations that do not meet basic criteria," Raj Kumar has observed, "The tougher challenge comes in evaluating an organization's positive impact."[122]

Recognizing these limitations, Charity Navigator sometimes allows nonprofits to post impact evaluations by third parties. Likewise, GuideStar highlights whether organizations share impact evaluations.[123] But to be clear, GuideStar does not conduct or even vet these evaluations; it merely indicates whether a nonprofit shares this information, but does not comment on whether the organization's methodology is sophisticated or, for that matter, whether the results are compelling.[124]

Another rating agency, GiveWell, relies on academic studies, instead of on Form 990. To advance its mission of helping poor people outside the U.S., GiveWell combs the academic literature for cost-effective interventions, such as distributing insecticide-treated nets and treating children for parasites.[125] GiveWell then invites charities that offer the relevant programs to provide specific information, which it reviews.[126] To its credit, GiveWell has found a way to go beyond the limited information in Form 990, but it rates only a targeted set of programs at a small number of organizations.[127]

3. *Influence*

Effective monitoring requires not only the right incentives and information, but also the necessary influence. On this dimension, rating agencies fare quite well. They wield significant influence through their readers. Board members, major donors, and prospective donors are likely to review their analyses, and managers obviously want the good will of these influential stakeholders. So if rating agencies express doubts about the impact or cost-effectiveness of

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122 *See* Kumar, *supra* note 9, at 55.

123 https://learn.guidestar.org/seals [https://perma.cc/D398-3XC4] (listing criteria for various levels of seals of approval, which turn on how much information the nonprofit shares).

124 *See* Kumar, *supra* note 9, at 56 (noting that GuideStar "rankings are more subjective, and not based on an agreed-upon system of external reviews").

125 *See* https://www.givewell.org/how-we-work/process [https://perma.cc/L4KY-DUPK]. ("Based on these investigations, we have concluded that: Highly rigorous evidence connecting aid activities to improved life outcomes . . . is found in academic literature, and not (in any cases that we've seen) in internal self-evaluations by charities.")

126 *See Id.* ("We invite eligible charities to participate in our intensive evaluation process, which aims to deeply and critically question the case for the charity's impact, and lay out what we see as the strengths and weaknesses publicly.").

127 *See* Kumar, *supra* note 9, at 57.

specific initiatives, or question other aspects of a nonprofit's operations, managers are unlikely to ignore this feedback

In some cases, modest donors and beneficiaries also read a rating agency's review. Even though individual members of these groups have only limited influence, their clout in the aggregate can be quite significant so, again, managers are likely to pay attention. In a sense, rating agencies can stand in for these groups, monitoring management on their behalf.

To sum up, rating agencies have strong incentives to monitor management and can wield significant influence. Yet to play this role effectively, rating agencies – like major donors – need better information about the impact and cost-effectiveness of nonprofit programs. The rest of this Article considers how to make this information more readily available.

III. COUNTERING INEFFICIENCY WITH A RIGOROUS PLANNING PROCESS

So far, this Article has identified a key source of inefficiency at nonprofits: instead of relying on profitability to measure success, they have to track their progress in other ways. As a result, even the best nonprofit leaders need to work harder to allocate resources efficiently, while less capable and committed leaders have more latitude to make self-interested and unwise choices. To discourage these flawed decisions, this Article urges boards, donors, and rating agencies to monitor management. Yet as the prior Part showed, these monitors need the right information to play this role effectively.

To address these challenges in measuring success and detecting mismanagement, this Part recommends a more rigorous planning process for nonprofits. Every year, they should update their mission, revisit their priorities, and search for ways to improve their programs. To guide this analysis, this Part recommends a set of questions for nonprofits to answer every year. After discussing these questions, this Part analyzes the benefits and costs of engaging in this analysis.

A. Three Questions

Too often, nonprofits keep doing what they have done before. Alarm bells that force for-profit firms to make painful changes — declining profits and share prices — do not ring at nonprofits. Longstanding initiatives endure, even as new ones are layered on top of them. Indeed, nonprofit programs are sometimes easier to explain with archeology than with logic.

Instead of assuming that existing programs should continue, nonprofits should periodically review all of their programs. The same standard should apply in deciding both whether to continue an existing initiative and whether to launch a new one: is this program the best use of the nonprofit's scarce resources?

In planning programs and setting budgets each year, nonprofits should strive to maximize social return, but how can they operationalize this somewhat abstract principle? To do so effectively, their planning process has to account for the context, since nonprofits vary widely in their missions and goals; universities, humanitarian organizations, and houses of worship need to analyze very different issues.

The planning process should also be tailored to the skill sets of nonprofit managers, who are often social workers, educators, religious leaders, doctors, and lawyers. While they know a great deal about the nonprofit's work, they often know less about econometrics, cost-benefit analysis, management theories, and other disciplines that could bear on choices they face.

To help nonprofits evaluate their programs' social return, this Section proposes three questions, which nonprofits should answer in writing every year. The author developed these questions as the CEO of an international humanitarian organization.[128] This Article refers to them as "the three questions" and refers to the nonprofit's answers as a "program analysis." The questions are general enough to apply to any nonprofit — whether they are soup kitchens, symphonies, or grant-making foundations. The questions use jargon-free language that should resonate with nonprofit managers and boards.

To be clear, the goal here is not to advocate for *these specific* questions, but for a rigorous written analysis – in whatever form – that assesses the relevance of a nonprofit's mission and the impact and cost-effectiveness of its programs. While the questions recommended here are a good starting point, nonprofits can tailor them to fit their work, organizational culture, and other institutional needs.

Nonprofits should also fine tune other details of the planning process. For example, the recommendation here is to produce a new program analysis every year, as a way to ensure that the annual budget reflects up-to-date priorities and strategies. Yet some nonprofits might prefer to conduct this analysis every other year. Still others might do a bare bones analysis some years, and a deeper dive in others (*e.g.,* every three or five years). It is essential to keep revisiting these questions, but reasonable minds can disagree about how frequently to do so.

1. *First Question: How Important are the Challenges the Nonprofit is Trying to Address?*

The social value of a nonprofit's work depends in part on its mission. What problem is it trying to solve, and why is this problem important? This question weeds out missions that become stale, such as the March of Dimes' efforts to eradicate Polio.[129]

This first question invites a nonprofit to make the case for its mission and key goals. Admittedly, there is no metric to compare the value of different goals, but a nonprofit can still

[128] The author initiated a practice of answering these questions in a new report every year, which analyzes all of the nonprofit's major activities in 70 countries across the world and explains how the $365 million budget is allocated. For the 2020 report, see https://www.jdc.org/wp-content/uploads/2019/12/JDC_Global_Strategy_2020_12192019.pdf [https://perma.cc/24JV-5ZEN].

[129] *See* March of Dimes, *About Us*, https://www.marchofdimes.org/mission/about-us.aspx [https://perma.cc/A453-DLH3] ("We pioneered the vaccine research leading to the eradication of polio in the U.S., and then we shifted focus to address some of the biggest health threats to moms and babies with innovations like folic acid, newborn screening and surfactant therapy.")

show why its goals are important. Instead of superlative adjectives and emotional anecdotes, its program analysis should offer data and analysis.[130]

To provide the right data – and, more generally, to demonstrate the urgency of the challenges it addresses – a nonprofit should define its goals clearly and specifically. For example, instead of saying it seeks "to help poor people," a nonprofit should say that it is "providing food and medicine to elderly in Ukraine" or "enhancing crop yields of Ethiopian farmers with innovative agricultural technology."

Once the nonprofit defines its goals clearly, it can offer objective facts to demonstrate their importance. For example, the nonprofit can report that daily government pensions for elderly in Ukraine are just two dollars, compared with thirty-two dollars in France and fifty dollars in the United States.[131] Similarly, the nonprofit can emphasize that 85% of Ethiopia's 109 million people earn their living from agriculture, and that the country's average income is only $2.16 per day.[132] Compelling facts speak for themselves. If the relevant facts are not compelling, the nonprofit needs to rethink its goals.

Information about the importance of a nonprofit's goals should not be hard to provide. After all, managers are supposed to know why their mission is important. They can draw on academic research and media coverage, which often is easier than gathering and analyzing data about their own programs and grants.

2. *Second Question: How Effective are the Nonprofit's Responses to These Challenges?*

Even if a challenge is important, social return is low if a nonprofit cannot address it effectively. So operating charities and funders should produce a detailed answer to a second question, which is harder to answer: how effective is their response to this problem?

a. Revisiting Priorities and Testing Improvements

This question presses nonprofits to keep revisiting priorities and testing potential improvements. In answering this question, nonprofits need to ensure that their approach is cutting edge and their costs are lean.

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130 *See* Gugerty & Karlan, *supra* note 8*,* at 6 ("Even though . . . stories [about individuals] may be compelling, they do not tell us the impact of the program on people's lives -- whether the program is actually working").

131 See https://finance.yahoo.com/news/heres-every-states-average-social-132355610.html [https://perma.cc/BV5F-MK3W] (average social security benefit in U.S. is $1,503 per month or about $50 per day); https://www.cleiss.fr/docs/regimes/regime_france/an_3.html [https://perma.cc/YVY8-YNUJ]. (French solidarity allowance for elderly brings monthly income €868.20 or approximately $32 per day, assuming an exchange rate of 1.085 dollars per Euro); https://www.ssa.gov/policy/docs/progdesc/ssptw/2018-2019/europe/ukraine.html (minimum pension in Ukraine for those aged 65 or older is 40% of 3,723 hryvnias (the monthly minimum wage) or 1,489 hryvnias; at an exchange rate of .037 dollars per hryvnia, this is $55.10 per month).

132 https://www.worldbank.org/en/country/ethiopia/overview [https://perma.cc/85X8-XXHF].

If a program is ineffective, they should shut it down. For example, if deploying agricultural technology in Ethiopia does not actually enhance crop yields, the effort should be discontinued.

Even when a program is effective, nonprofits should try to make it better. If crop yields are already increasing by 25%, what would it take to increase them by 50%? Or could the nonprofit get the same result while spending 15% less? Is there a less expensive technology? Can management costs be reduced? Innovative organizations constantly search for better approaches, and this second question invites nonprofits to engage, restlessly and relentlessly, in this sort of constant experimentation.

To benefit from these experiments, nonprofits need the right planning process. Along with collecting reliable information about their results, they need to incorporate this information into their decision-making process, so it contributes to organizational learning.[133] The first two questions push organizations to take these steps.

In encouraging constant goal-setting and analysis, these questions resemble "OKR" or "Objectives and Key Results," a management approach used at Google and other leading for-profit firms. Under OKR, at the beginning of the relevant period, which might be the month, quarter, or year, senior managers specify between five and ten objectives, along with "key results" that measure their progress. Managers monitor these key results throughout the period, and then refine or change their objectives and key results for the following period.[134]

b. Measuring Progress

In constantly reexamining their work, what results should nonprofits monitor? To assess whether their response to a problem is effective, they need to define success. Since profitability is not relevant, other benchmarks are needed.

Perhaps the most basic metric is the quantity of goods and services a nonprofit produces, which are called "outputs." Nonprofits should track the number of people they serve, the services they provide, and the average cost per unit of these services. Without this information, managers and boards have at best an abstract sense of how they are addressing the relevant issue. This information also can help them improve operations, for instance, by looking for ways to reduce the cost per unit delivered.[135]

While outputs are a necessary measure of progress, they are not always sufficient. For example, to determine the impact of agricultural technology on Ethiopian farms, the units of technology delivered are less relevant than the increase in crop yields; the latter indicator, known

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[133] *See* Gugerty & Kalman, *supra* note 8, at 69 ("If monitoring data are to support program learning, they must be incorporated into organizational decision making processes.").
[134] *See generally* John Doerr, *supra* note 46.
[135] *See* Gugerty & Kalman, *supra* note 8, at 69 (referring to output measures and related information as "monitoring," which helps "you understand whether you are doing what you set out to do and to improve how you do it").

as an "outcome," measures social benefits more directly.[136] Put another way, if you deliver the equipment, does it *actually work*?[137]

Although outcomes are usually more informative, outputs can still be a reasonable measure of social return in some cases. For example, if desperately poor elderly clients would die without food and medicine, the quantity delivered, the number of clients, and cost per client give a meaningful sense of social return. Ideally, a nonprofit also would track relevant outcomes, such as impact on life expectancy and quality of life. Yet these outcomes are harder to measure, and arguably are unnecessary in this context, since the causal link between outputs and outcomes is so clear.

Since the work of nonprofits varies so dramatically, goals and metrics will be correspondingly diverse. Yet every nonprofit has outputs, outcomes, and other metrics that shed light on their effectiveness. At first blush, this observation may seem more persuasive for social service providers and health care providers, since their work is somewhat easier to quantify.[138] Yet the same is true, at least to an extent, of organizations with less concrete missions.

Perhaps the quintessential example is religious organizations. Needless to say, fundamental aspects of their value turn on faith, which cannot be quantified or even verified. Yet these institutions also provide goods and services that are straightforward to evaluate, including the size of their membership, attendance at religious services, the vibrancy of their other programming, and the strengths and weaknesses of their professional leadership.[139]

The analysis is similar for museums and orchestras. They are supposed to promote artistic achievement, offer opportunities to be inspired and educated, and serve as stewards of our cultural heritage. Yet although the value of specific performances and exhibits can debated — as, indeed, can the social significance of their missions — these institutions can still measure their success, at least in part, by the size of their audience, the number of return visitors, average operating cost per visitor, the perspective of expert critics, and the like.[140]

Likewise, universities are supposed to prepare students to live successful and fulfilling lives, while also strengthening democracy and advancing the frontiers of knowledge. Admittedly, there is no way to measure each university's precise contribution to this effort, but a range of

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[136] Martha Taylor Greenway, *The Emerging Status of Outcome Measurement in the Nonprofit Human Service Sector, in* Measuring Impact, *supra* note 8, at 217, 225 ("All [output measures] tell us is how much effort has been generated for how many people. They tell us nothing about whether this effort has made any difference.").
[137] *See* Gugerty & Kalman, *supra* note 8, at 69 (distinguishing "impact evaluation," which analyzes whether the intervention has produced the desired social change, from "monitoring evaluation," which analyzes whether it has been implemented reliably and cost-effectively).
[138] *See*, *e.g.,* Greenway, *supra* note 136, at 217 (impact measures for social services); *see also* Bradford Gray, *Measuring the Impact of Nonprofit Health Care Organizations*, *in* Measuring Impact, *supra* note 8, at 185 (impact measures for health care).
[139] *See*, *e.g.,* Robert Wuthnow, *The Religious Dimensions of Giving and Volunteering*, *in* Measuring Impact, *supra* note 8, at 231 (impact measures for religious institutions).
[140] *See, e.g.,* Margaret Jane Wyszomirski, *Revealing the Implicit: Searching for Measures of the Impact of the Arts*, *in* Measuring Impact, *supra* note 8, at 199 (impact measures for the arts sector).

familiar factors shed light on its success, including the credentials of students and faculty, student-faculty ratios, citation counts, reputation surveys, and job placement records.[141]

Since measuring impact directly can be challenging, nonprofits sometimes use indirect measures, although these have limitations. For example, reputation surveys convey whether third parties *believe* a nonprofit is effective,[142] but their reliability depends on whether participants are well-informed and objective, and whether the right questions are asked.

Another indirect measure focuses on process, instead of outcomes. The theory is that good processes, which are relatively easy to observe, are likely to generate good outcomes. Has a nonprofit adopted best practices, such as an annual planning process and a board with independent directors?[143] Yet although best practices are relevant, they tell us nothing about the importance of a nonprofit's mission and relatively little, at least directly, about the impact and cost-effectiveness of its programs.

As noted above, there are risks in relying on imperfect measures of social return. Managers might overemphasize features they are measuring, while neglecting key goals their metrics don't track. A familiar example is the emphasis of university rankings on standardized test scores and grades, which motivates some universities to undervalue applicants' other important strengths.[144] Yet the right response to this challenge is to fine-tune the metric, not to abandon efforts to monitor progress.

c. Drawing Comparisons

In monitoring results, nonprofits need to make comparisons. Which programs are producing the best results and which are underperforming? If a program is tweaked, does the modification make it more or less effective?

The goal of these comparisons is to figure out which initiatives offer the highest social return, so nonprofits can focus on those, maximizing the impact of each dollar they spend. In

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141 *See generally* Douglas C. Bennett, *Assessing Quality in Higher Education*, 87 Liberal Education (2001), https://www.aacu.org/publications-research/periodicals/assessing-quality-higher-education [https://perma.cc/JD8K-3PGK] (describing various approaches to measuring quality in higher education); *see also* James P. Connell & Adena M. Klem, *A Theory of Change Approach to Evaluating Investments in Public Education, in* Measuring Impact, *supra* note 8, at 173 (impact measures for public education sector).
142 *See* Daniel P. Forbes, *Measuring the Unmeasurable: Empirical Studies of Nonprofit Organization Effectiveness From 1977 to 1997,* 27 Nonprofit & Voluntary Sector Quarterly 183, 186 (1998) (describing "perception-based or reputational approach" to measuring organizational effectiveness of nonprofits).
143 *See, e.g.*, Kellie C. Liket & Karen Maas, *Nonprofit Organizational Effectiveness: Analysis of Best Practices*, 44 Nonprofit and Voluntary Sector Q. 268 (2015) (evaluating nonprofits based on survey measuring utilization of best practices); Forbes, *supra* note 142, at 190 (noting studies that seek correlation between specific processes and effective outcomes).
144 *See, e.g.,* Benjamin Wermund, *How U.S. News College Rankings Promote Economic Inequality on Campus*, Politico, Sept. 10, 2017 ("criteria used in the U.S. News rankings . . . create incentives for schools to favor wealthier students over less wealthy applicants").

general, there are two ways to make these comparisons: cost-benefit analysis and cost-effectiveness analysis. Each has advantages and disadvantages.

The Robin Hood Foundation, a prominent nonprofit whose mission is to improve the income and health of low-income New Yorkers, is an enthusiastic proponent of cost-benefit analysis. To compare the impact and cost-effectiveness of different initiatives, they assign a dollar value to a program's social benefit (*e.g.,* $50,000 for placing someone in a job). Robin Hood divides the total benefit (*e.g.,* $1 million for a program placing 20 graduates) by the program's cost (*e.g.,* $200k), and uses the resulting ratio (*e.g.,* $1 million/200k, or 5) to compare different initiatives.[145] In theory, an advantage of this approach is the ability to compare dissimilar outcomes (*e.g.,* job placement versus medical care).

Yet because this methodology depends on estimates that can be difficult to compute, its precision sometimes is more apparent than real. For example, to compare the value of raising incomes with the value of improving health, Robin Hood must assign a dollar value to the benefit of each type of program. This is easier for income initiatives (which generate dollars) than for health initiatives (which extend life). For the latter, Robin Hood estimated the value of extending life for one year. Yet when health initiatives consistently outperformed income initiatives, Robin Hood responded — not by discontinuing income initiatives — but by reducing their estimate for extending life (from $100,000 to $50,00), so income initiatives would be more competitive.[146]

Invoking this decision, a cynic might say that Robin Hood believes in their methodology only when it confirms what they already think, but this is unfair. When Robin Hood's analysis does not align with their intuitions, they take a harder look at their assumptions. This is the right thing to do.

Even so, there is an important lesson here: looking at the ratios alone is not sufficient, since the assumptions underlying them are so important. Rather, to compare two initiatives, it is necessary to consider the entire analysis. Indeed, Robin Hood's experience comparing income and health programs highlights the imprecision of cost-benefit analysis and, more fundamentally, the difficulty of determining the relative value of very different initiatives.

In contrast, when programs advance similar goals, rigorous comparisons are easier. Instead of estimating the dollar value of outcomes, nonprofits can simply track outcomes directly, and estimate what they spend to achieve them. This approach is known as cost-effectiveness analysis.

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[145] *See generally* Weinstein & Bradburd, *supra* note 9*,* at 1-16 (describing Robin Hood's strategy of "relentless monetization" or RM).

[146] *See id.* at 36 ("The danger was that Robin Hood's funding decisions, assuming health gains would be measured at $100,000 per QALY [quality-adjusted life year], would be biased toward health-related interventions and therefore away from income improving interventions . . . Robin Hood has since set the monetized value of a QALY at $50,000 and allocated grants accordingly.")

For example, a nonprofit that provides job training can track the number of trainees placed in jobs, while a hospital can track patients successfully treated for a disease.[147] In each case, the nonprofit can compute its average cost per successful outcome and compare it with the cost of other ways to attain the same outcome. In other words, cost-effectiveness analysis compares programs with the same goal (*e.g.,* job placement), identifying which advances it most efficiently.[148]

Cost-effectiveness analysis poses two challenges, though. First, in drawing these comparisons, nonprofits need to assure that the outcomes actually are comparable; notably, adjustments are needed to account for differences in quality.

Second, this approach cannot compare programs with very different goals (*e.g.,* jobs versus health). This is a key difference from cost-benefit analysis, which can be used (however imperfectly) to compare dissimilar outcomes.[149]

3. *Third Question: Is the Nonprofit the Right Organization to Respond to These Challenges?*

Even when a nonprofit targets a compelling issue with a cost-effective response — thereby offering persuasive answers to the first two questions — it still needs to address a third question: Is the nonprofit the right organization to take on this challenge? In other words, does it have a comparative advantage over other nonprofits that are addressing the issue?

This question is easy to answer when a nonprofit is "the only game in town." If no one else is taking on an important problem, and the nonprofit's response is effective, it clearly is offering unique value. Admittedly, this is not the typical situation. When a problem is important, other organizations usually also try to address it, but not always.

When the field is more crowded, nonprofits should push themselves — frankly, more than they usually do — to justify why they should do work that others are also doing. The third question urges a nonprofit to prioritize work that others cannot do as well.

What are the nonprofit's unique strengths? Does it have special expertise? A hospital specializing in cancer research has obvious advantages in treating cancer patients. Does a nonprofit's location give it an edge? A law school based in D.C. can offer students easier access to experiential opportunities in the federal government. Has the nonprofit built an infrastructure for one job which enables it to take on another? A nonprofit that already cares for Holocaust

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[147] *Cf.* Kenneth C. Land, *Social Indicators for Assessing the Impact of the Independent Not-for-Profit Sector of Society, in* Measuring Impact, *supra* note 8, at 69-73 (giving examples of indicators for different types of nonprofits).

[148] *See, e.g.,* Acumen Fund Metrics Team, *supra* note 27, at 3 ("The BACO calculation ultimately conveys the net cost per unit of social impact.").

[149] The World Bank DIME Wiki ,*Cost-effective Analysis*, , https://dimewiki.worldbank.org/wiki/Cost-effectiveness_Analysis [https://perma.cc/TQ8M-7GGB] (comparing cost-effectiveness analysis to cost-benefit analysis).

survivors enjoys economies of scale in caring for other elderly. Comparative advantages obviously can arise from other qualities as well, including a unique reputation, better access to clients, and close ties to key operating partners or funders.

In urging nonprofits to focus on their comparative advantages, the third question echoes a key theme in *Good to Great*, a classic management text that seeks to explain how merely competent for-profit firms can become market leaders. The author, Jim Collins, urges companies to figure out "[w]hat you can be the best in the world at (and, equally important, what you cannot be the best in the world at)."[150]

At first blush, this might seem obvious, but the temptations to stray from core competencies are familiar. Like their for-profit counterparts, nonprofit managers often view expanded operations as a source of prestige and even a justification for higher pay. There is also glory in addressing trendy issues, even if they are not a good fit with the nonprofit's mission and expertise. Since nonprofit managers are judged in part by their fundraising totals, they have reason to accept gifts for programs they would not otherwise prioritize and might not implement effectively. As long as the success of these programs is hard to measure, managers won't pay a price for mediocre results. The third question, then, is a necessary antidote to these empire-building impulses.

B. Benefits of Preparing a Program Analysis

A rigorous planning process, which generates insightful and detailed answers to the three questions, can offer important advantages even if it is shared only internally (or, at least, selectively). To be clear, though, these benefits are not automatic.

To generate them, the team preparing this analysis must have the right skills, motivation, and authority. Ideally, they are able to ask hard questions, test assumptions, gather and analyze data, balance competing considerations, make wise judgments, and document and explain their conclusions. The planning team also must be willing to consider significant changes. Their focus should be on the mission, not on their own interests. Instead of trying to justify the status quo, they need to reimagine the nonprofit's work, reset priorities, and hunt for improvements. The planning team also needs adequate authority. The nonprofit's most senior leaders should be personally involved, and the planning process should include ways to generate feedback and "buy in" from other key stakeholders. Yet even when these conditions are not satisfied, a program analysis can still add value, if only in alerting the board to management's limitations.

A planning process that satisfies all (or even some) of these requirements can yield five significant benefits. First, even if senior managers are the only ones involved, the three questions encourage them to develop a better strategy. These questions urge them to revisit priorities, monitor progress, improve high-value programs, and shut down ineffective ones. Admittedly, the analysis might not turn out as thoughtful or sophisticated as it should be, but it still should push managers in the right direction.

Second, the three questions encourage a nonprofit not only to develop a better strategy, but also to implement it more effectively. When managers commit their goals to writing, they

150 Jim Collins, Good to Great 95 (2001).

have greater incentive to achieve them, if only because failure becomes more visible. In addition, by sharing the program analysis with all employees, managers can promote "buy-in" and ensure that everyone knows how their work fits into the overall strategy.[151] A process that revisits the three questions each year also has the potential to change a nonprofit's culture; when senior managers become more goal oriented and data driven, others are likely to follow their example.

Third, sharing a program analysis with the board raises the reputational stakes for managers, so they are even more motivated to achieve their goals. In addition, the board can exert more meaningful oversight. Although board members usually have less expertise than managers do about the nonprofit's work, as noted above, a program analysis helps to redress this imbalance. It gives the board something specific to evaluate and empowers them to provide substantive input. Admittedly, the board is not always motivated to detect and block self-interested and unwise managerial choices, but when they *are* motivated, a program analysis can help them do so. In reviewing it, they can comb for red flags, such as declining demand, rising costs, and unpersuasive priorities. If the board is concerned about any aspect of the program analysis, they can ask for changes and then review a revised version. Even after approving it, the board can still ask for updates on specific issues. In short, if board members are motivated to monitor management, a program analysis can help them discharge this responsibility a lot more effectively.

Fourth, a program analysis can also empower donors who are eager to serve as monitors, while also enabling nonprofits to respond more effectively to donors' requests for information. An increasing number of donors — especially professionally run foundations — have begun requiring more sophisticated program evaluations.[152] In principle, this is a promising trend, but the funders' role is a mixed blessing. On the one hand, donors obviously have significant influence, so they can push nonprofits to be more effective, as long as they focus on the right issues. But on the other hand, donors have limited knowledge of their grantees' work. As a result, donors sometimes ask the wrong questions, requiring managers to gather data that is not especially illuminating. Indeed, managers may scramble to respond to multiple funders, whose questions are not framed well enough to test (or improve) the nonprofit's work.[153] A better approach is for the nonprofit itself to pose the right questions and offer the relevant information. This better outcome is more likely if managers *already* are engaging in rigorous internal reviews — as they should do in answering the three questions. They can then urge funders to accept data and analysis that they already are generating.

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[151] *See generally* Doerr, *supra* note 46 (describing morale and other benefits of articulating organizational goals).

[152] Patrick Flynn & Virginia A. Hodgkinson, *Measuring the Contributions of the Nonprofit Sector*, *in* Measuring Impact, *supra* note 8, at 4 ("In an increasingly competitive world in which nonprofits operate, there are new demands for impact analysis.")

[153] *See* Gugerty & Kalman, *supra* note 8, at 68 ("[W]hile reporting requirements are important for funding organizations to track their work, they often require grantee organizations to collect information that does not help improve operations."); Alexander, Brudney & Yang, *supra* note 104, at 566-67 ("Nonprofit funding may derive from dozens of sources, each with its own processes and measures of performance, time lines, indicators, and tracking and reporting. . . . As a result of such daunting complexity, the practitioners felt that the potential of using performance measurement as a management tool is squandered and has not led to greater transparency or better decision making.").

Fifth, and relatedly, by producing a clear strategy and sharing it internally, a nonprofit can speak with one up-to-date voice in addressing external audiences. For example, the program analysis can help make the case to traditional funders, who focus more on good intentions than on impact. As noted above, these funders may be disappointed that programs they have supported for years need to be retooled or replaced.[154] To bring these donors around, a nonprofit usually relies on its fundraisers, who are supposed to form close ties with them. Yet in order to "sell" the new strategy, fundraisers need to understand it. This does not happen automatically, since fundraisers are not usually involved in program planning. Fortunately, the program analysis supplies the details they need. Indeed, without it, fundraisers might play a counterproductive role by continuing to "pitch" the old approach. In the same way, the program analysis also helps the marketing department update their messaging to journalists, online donors, and other key audiences.

C. Costs of Preparing a Program Analysis

As the last Section showed, answering the three questions offers significant benefits, even if the answers are not shared widely. Yet this exercise is not cost-free. This Section highlights three costs, which should be manageable at most nonprofits.

First, and most fundamentally, preparing rigorous and comprehensive answers requires time and effort. Hours invested in this analysis cannot be devoted to other tasks, including work with beneficiaries and fundraising. Some managers are reluctant to serve fewer clients or to lay off program experts or fundraisers in order to fund a more rigorous planning process.

Yet if this investment helps them deploy resources more efficiently, they would serve beneficiaries more effectively. Rigorous planning also can inspire confidence in donors, attracting more resources for the nonprofit's work. As a result, skimping on planning turns out to be a false economy in many cases.

The value of investments in planning increases with a nonprofit's size and complexity. For example, a nonprofit that runs only one program, which is valuable and runs efficiently, has less need to reevaluate goals and operations every year than one with multiple programs. Yet even though simple nonprofits have less need for this process, they can run it more easily. Since there are fewer hard questions to answer, a simple (and relatively inexpensive) process is adequate, and this "bare bones" process is likely to be cost-justified. Arguably, then, *every* nonprofit should provide at least basic answers to the three questions – or, at least, every nonprofit with a budget or employee head count above a minimum level — while larger and more complex nonprofits should provide more comprehensive answers.

A second cost of preparing a program analysis is that key stakeholders have to make difficult (and even unpleasant) choices. For example, some professionals are viscerally uncomfortable with quantifying (and ranking) the needs of different populations. They regard this approach as cold-hearted and better suited to the commercial world they escaped in working at nonprofits. Likewise, board members who view nonprofits as a refuge, where they share inspiring experiences with interesting people, may not want to grapple with unpalatable choices.

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[154] *See supra* Part II.E.1.

Yet although these choices may be unpleasant, they are unavoidable. Because resources are limited, nonprofits inevitably have to prioritize some beneficiaries and programs over others. The question is not whether – but how – to make these judgments. They can be made either explicitly or implicitly. The better course is to confront them head-on, instead of defaulting to an answer, for instance, by reflexively continuing the status quo or deferring to donor preferences. In preparing a program analysis, managers and boards have the opportunity to make important choices the right way.

Finally, there is a risk that they will not take this task seriously or approach it honestly. Managers and boards who "go through the motions" of answering the three questions will not get much from this effort. They are wasting their time if they merely offer disingenuous arguments to justify self-interested choices. Fortunately, attentive readers should be able to recognize this sort of empty analysis.

Indeed, since attentive readers can motivate managers and board members to produce a better analysis, there are advantages to sharing it more broadly. The next Part considers advantages and disadvantages of disclosing a program analysis to the public.

IV. COUNTERING INEFFICIENCY WITH BETTER DISCLOSURE

Because success is hard to measure at nonprofits, efficient resource allocation is challenging even for dedicated and competent managers and board members. For the same reason, self-interested and incompetent choices are harder to detect. To address these challenges, the prior Part recommended a more rigorous planning process, in which nonprofits answer three questions every year. Preparing this program analysis yields a number of advantages, even if the nonprofit does not share it widely. Yet disclosing this analysis to the public offers additional advantages. This Part urges nonprofits to take this step, identifying both advantages and costs of doing so.

A. Three Benefits From Disclosing a Program Analysis

This Section considers three benefits of disclosing a program analysis to the public: first, donors and rating agencies can monitor agency costs and incompetence more effectively; second, donors can make more informed choices; and third, nonprofits can more easily borrow innovative ideas from each other.

1. Countering Agency Costs and Inertia

One advantage of sharing a program analysis with the public is that managers and board members are likely to work harder on it. Since the analysis is visible to a wider audience, they have a greater reputational stake in producing a comprehensive document and reporting strong results.

Disclosing this analysis also helps a nonprofit to recruit more monitors.[155] As noted above, major donors usually have significant influence with nonprofits and want to get the most for their money. But to serve as effective monitors, they need detailed information on programs, which a program analysis can provide.

Rating agencies also need this information. As noted above, they usually focus on topics that Form 990 covers, such as governance and solvency. Yet if rating agencies also can review a nonprofit's program analysis, they can offer more insights about programs.

Ideally, in monitoring nonprofits, rating agencies and donors would compare the performance of different organizations. Likewise, managers and board members should use their peers' performance as benchmarks. Yet these comparisons obviously require information about all the relevant nonprofits. If each nonprofit discloses a program analysis, comparisons become more feasible.

Even then, comparisons are not wholly reliable unless nonprofits share similar information and compute it the same way. For example, even if two charities report their average cost in providing a particular service, the comparison is not illuminating if they calculate it differently.[156] As a result, disclosure conventions and methodologies become more valuable when used more widely. These network effects only arise, though, when nonprofits are similar enough to be compared. For instance, it is important for two soup kitchens to disclose the same way, but not for a soup kitchen and an orchestra to do so.

For nonprofits with similar missions, disclosure practices can converge in various ways. For example, if the same major funders support the relevant nonprofits, these funders can ask for a particular format and methodology. Likewise, rating agencies and media outlets that publish rankings can exert comparable influence by specifying what they evaluate.

Ideally, these shared conventions would develop gradually and flexibly, so different variations can be vetted, refined, and compared; premature standardization could prevent better approaches from emerging. Industry organizations can help to manage this process, mediating among competing approaches and (eventually) giving some a "seal of approval." In principle, regulators also can play this role. Yet in deciding how nonprofits should measure success, regulators would inevitably influence what nonprofits prioritize, and this sort of substantive oversight has disadvantages, as discussed above.[157]

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[155] Weinstein and Bradburd argue that sharing goals and metrics empowers others to decide whether they agree with the analysis. Their emphasis is not the need to monitor self-interested decisions or incompetence, but the value of debate in refining the relevant analysis. *See* Weinstein & Bradburd, *supra* note 9, at 36 ("Explicit figures make it possible for interested parties -- donors, employees, outside experts -- to take a critical look and decide for themselves whether they like what the funder has done. Critics are free to substitute their own figures. . . By making metrics explicit, funders can invite debate and revision."); *see also id.* at 95 ("Internal politics, favoritism, habit, difficult personalities never disappear altogether, but all matter less for making grants when conversation focuses on outcomes-based evidence.").

[156] For example, one might include overhead (*e.g.,* the cost of senior management's time) while the other does not.

[157] *See supra* Part II.B.

Admittedly, a program analysis cannot turn every donor and rating agency into a perfect monitor. Some will still lack the necessary incentives, expertise, or influence. Yet when product market competition is limited and boards are passive or disengaged, donors and rating agencies are the best available monitors, as noted above. They need information to play this role.

2. Better-Informed Resource Allocation in the Nonprofit Sector

Disclosing a program analysis to the public empowers donors not only to serve as monitors, but also to make better-informed choices. Donors often need detailed information to ensure that charities share their goals. For example, some environmental organizations support nuclear power, while others oppose it, as noted above.[158] Since these variations are not always obvious to outsiders, donors might mistakenly fund work they consider unappealing or even offensive. Public charities can prevent these mismatches by sharing program analyses with the public.[159]

Better-informed decisions are good not only for donors, but also for society as a whole. With better information, donors are more likely to choose the most productive philanthropic opportunities. A similar justification is commonly invoked for disclosure in capital markets, which is required under the U.S. securities laws. In providing accurate information, "the ultimate goal of securities regulation," Zohar Goshen and Gideon Parchomovsky wrote, "is to attain efficient financial markets."[160] According to Jack Coffee, "The beneficiaries of increased allocative efficiency include virtually all members of society, not just investors."[161]

Yet disclosure arguably is even more important in nonprofits. After all, for-profit (public) firms offer another way to monitor changed circumstances: share prices. When investors trade on private information, the changes they trigger in share prices are visible, even to those who are not privy to the underlying information. Yet nonprofits cannot impound undisclosed information in the same way. Perhaps the closest substitute for nonprofits is a high profile donation. When a donor with private information gives generously, others with less information may follow her example. But donations — even high profile ones — are usually less visible than changes in stock prices. As a result, disclosing the underlying information becomes all the more important at nonprofits.

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[158] *See supra* Part I.C.3.

[159] A private foundation is permitted to accept donations only from a small group. To ensure that its donors are informed, a private foundation needs to share information only with this group, and does not also have to share it with the public.

[160] Goshen & Parchomovsky, *supra* note 68*,* at 713.

[161] John C. Coffee, *Market Failure and the Economic Case for a Mandatory Disclosure System,* 70 Va. L. Rev. 717, 736 (1984); *see also* Frank H Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 Va. L. Rev. 669, 673 (1984) ("A world . . . without adequate truthful information . . . is a world with too little investment, and in the wrong things to boot.").

3. *Better Dissemination of Innovative Ideas*

Sharing a program analysis with the public also helps nonprofits learn from each other. When they incubate a successful initiative, disclosure allows other nonprofits, government agencies, and for-profit firms to replicate it, make improvements, and help more people. Failures also offer valuable lessons about what to avoid. To improve each other's work, even as they operate independently, public charities and private foundations need to disseminate knowledge. As Michael Dorf and Charles Sabel put it, "linked systems of local and inter-local or federal pooling of information . . . enable the actors to learn from one another's successes and failures . . . ."[162]

Yet like any effort to promote innovation, a rule directing nonprofits to disclose a program analysis requires a balancing of familiar considerations. On the one hand, sharing information spares would-be innovators from "reinventing the wheel." On the other hand, it can reduce the private return from innovating.[163]

Arguably, eroding this return should be less of a concern at nonprofits, since financial rewards are not supposed to motivate their stakeholders. If their goal is to advance the nonprofit's *mission*, as opposed to its *competitive position*, they might favor disclosure as a way to enhance their impact. Yet this altruistic perspective is more likely at some nonprofits (*e.g.,* soup kitchens) than others (*e.g.*, rival universities).

Obviously, there are a range of ways to balance these competing considerations. For example, sensitive information such as trade secrets and fundraising strategies can be exempt from disclosure, or this disclosure can be delayed.[164] Alternatively, competitors can be allowed to borrow an idea only if they negotiate a license, give credit to its creator, or comply with some other condition. An analysis of these (and other) alternatives is beyond this Article's scope.

B. Costs of Disclosing a Program Analysis

As the prior Section emphasized, disclosing a program analysis can reduce agency costs, improve resource allocation, and disseminate ideas. Yet these benefits come at a price. This Section surveys the main costs of this disclosure.

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[162] Michael C. Dorf & Charles F. Sabel, *A Constitution of Democratic Experimentalism*, 98 Colum. L. Rev. 267, 287 (1998).

[163] *Cf.* Easterbrook & Fischel, *supra* note 161, at 708 ("A new product might be profitable if built in secrecy, stealing a march on rivals; if the rules require advance disclosure, rivals' responses make the project less attractive.").

[164] *See* Treas. Reg. § 301.6104(a)-5 (nonprofits are exempt from disclosing a "trade secret, patent, process, style of work or apparatus" if the I.R.S. "determines that the disclosure of information would adversely affect the organization"); Andrew Masak, *Steps to Protect Trade Secrets in the Non-Profit Sector and Balance the Need for Transparency*, Trade Secrets, (Aug. 19, 2014) https://www.tradesecretslaw.com/2014/08/articles/trade-secrets/not-for-profit-not-entitled-to-trade-secret-protection-no-so-fast-steps-to-protect-trade-secrets-in-the-non-profit-sector-and-balance-the-need-for-transparency/ [https://perma.cc/7RFV-DPLD].

1. *Cost of Preparation*

If a nonprofit is already producing a program analysis to use internally, the incremental cost of *disclosing* it is modest. Documents from their internal process can be adapted for a less knowledgeable audience and trade secrets or other confidential information can be removed. This redrafting should not be costly. Indeed, many nonprofits already produce reports for some donors, as noted above, and often produce multiple versions when donors request different information.[165] Producing a standard version (with a supplement answering donor-specific questions) could actually *reduce* their reporting costs.

2. *Cost of Inaccuracy*

To offer the monitoring and other benefits discussed above, disclosure must be accurate. Misstatements can distort behavior and cause resources to be misallocated.[166] By concealing self-interested choices or overstating the impact or cost-effectiveness of its programs, a nonprofit might attract donations that should go to more efficient competitors. Similarly, disclosure that exaggerates the effectiveness of a new approach could induce other charities to adopt it in error.

3. *Cost of Assuring Accuracy*

To minimize these distortions, the accuracy of disclosure must be policed, and this effort requires resources. Relying on individual donors to verify the accuracy of disclosure is inefficient, since they lack key information and would duplicate each other's efforts in acquiring it. Since managers and board members already have this information, the most efficient strategy is to rely on them to share it, while motivating them to be accurate.[167] For example, like with financial statements, auditors can be enlisted to verify key facts in a program analysis. At many nonprofits, an auditor already helps to prepare Form 990, and can be retained to review a program analysis as well.

Since they issue a steady stream of communications — from paid advertising and glossy brochures to emails and videos — nonprofits need to clarify which ones are meant to be strictly accurate. For example, a program analysis could include a legend saying that it has been certified by managers under penalty of perjury or verified by an auditor. In communications without this sort of legend, the audience would know to expect (and discount) emotional appeals, evocative anecdotes, and exaggerated claims, which are the grist of advertising.

To reinforce the incentive of management (and auditors) to produce accurate program analyses, regulators or private plaintiffs have to scrutinize them for inaccuracies, and a

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[165] *See* Prakash & Gugerty, *supra* note 11, at 35 (added complexity when donors "vary in their information requirements").
[166] *See* Easterbrook & Fischel, *supra* note 161, at 678 ("The costs of . . . inaccurate enforcement are hard to see but no less real.").
[167] *Cf.* Goshen & Parchomovsky, *supra* note 68, at 779 ("managers, as insiders, can verify information more cost-effectively").

mechanism also is needed to resolve disputes. An investment of resources is needed here, as well as a choice about who should assume this responsibility.

Perhaps the most straightforward option is to require nonprofits to include a program analysis in Form 990, and to make the I.R.S. responsible for policing its accuracy. Yet the I.R.S. may not want this job, which does not advance its main mission of raising revenue.[168] Another alternative is for state AGs to take on this responsibility or share it with the I.R.S.[169] As a backstop, donors can already bring some private law suits under current law, including common law fraud.[170] Additional legislation or contractual provisions can also be considered to facilitate and regulate private law suits.[171] Each alternative would require significant resources, for instance, to fund more staff at the IRS or the attorney general's office or to cover fees for plaintiffs' lawyers. In addition, nonprofits would incur costs in defending actions, as would courts or arbitrators in adjudicating them.

To avoid under- and over-enforcement, penalties and liability standards should be carefully calibrated. In principle, nonprofits have optimal incentives to be accurate when they expect (on average) to pay fines equal to the harm caused by their misstatements.[172] Yet estimating this harm is challenging, so penalties are likely to diverge significantly from this ideal.[173]

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[168] *See* Swords, *supra* note 109*,* at 575 (I.R.S.'s main interest in Form 990 is whether "there might be money that ought to be taxed").
[169] *See id.* at 576 (compared with I.R.S., state charities office has a broader interest in protecting the public's interest in charities).
[170] Under common law fraud, a charity's misrepresentation must be material and intentional, and donors must have reasonably relied on it and been harmed as a result; a charity's intent and donor reliance are hard to prove. Sean Hayes, *Proving Civil Fraud in NY*, N.Y. L. BLOG, (Feb. 22, 2016), https://www.thenewyorklawblog.com/2016/02/ny-fraud-in-new-york.html [https://perma.cc/RBV4-QGLX]. An action under state consumer protection law is easier, but yields lower damages. *See id.* (explaining that New York's Deceptive Practices Act caps damages at $1,000). Some states also offer damages for "charity fraud," which targets deceptive practices, including phony charities that do not actually serve clients. Marguerite Keane, *Charity Fraud*, Encyclopedia Britannica (Oct. 11, 2019), https://www.britannica.com/topic/charity-fraud [https://perma.cc/DL43-N3K5] ("money solicited by persons or groups that are not legitimate charitable organizations constitutes charity fraud"). Notably, donors generally do not have standing under current law to enforce fiduciary duties. Joseph Meade & Michael Pollack, *Courts, Constituencies, and the Enforcement of Fiduciary Duties in the Nonprofit Sector*, 77 U. PITT. L. REV. 281, 299 (2016) ("Donors typically do not have standing, nor do the customers or beneficiaries of the nonprofit's programs.") (footnotes omitted).
[171] For example, one option is for nonprofits to commit to meet the standards of industry associations, and to rely on these associations to police their compliance. *See* Prakash & Gugerty, *supra* note 11, at 34-35. Another option, recommended by Geoffrey Manne, is for nonprofits to contract with private monitors, authorizing them to sue "to enforce charitable obligations, fiduciary duties, and certain members' rights . . . ." Manne, *supra* note 11, at 253. If nonprofits issue the program analyses recommended here, Manne's proposal — which contemplates litigation about mismanagement — could be retooled to police inaccuracies in this disclosure. *See id.* Manne's proposal is appealing in recommending mandatory arbitration to limit costs and deter strike suits, but it involves a conflict of interest, which he acknowledges: Manne expects nonprofit managers to hire these monitors, but a monitor who depends on managers for her job might hesitate to challenge them. *Id.* at 261-62. Industry associations face similar conflicts, since vigorous enforcement might deter nonprofits from committing to their standards.
[172] As a result, the penalty should reflect both the harm and the likelihood of detection. For example, if a misstatement causes harm of $100,000, and every misstatement is detected, the fine should be $100,000. But if only half are detected, the fine should be doubled to $200,000, so the average fine ($100,000) still equals this harm.
[173] For example, the penalty for filing an incomplete Form 990 is up to $50,000. I.R.C. § 6652(c)(1)(A). Since Form 990 is a tax return, general penalties for misstatements also apply. *See* I.R.C. § 7206 (providing for a fine of up to

4. Balancing Costs and Benefits

In choosing penalties, standards of liability, and enforcement mechanisms, policymakers need to manage tradeoffs among the costs discussed above. On the one hand, more vigorous enforcement means enforcement costs are higher (*e.g.,* more legal fees, more regulators, *etc.*). But on the other hand, disclosure is more likely to be accurate, so the cost of inaccurate disclosure is reduced (*e.g.,* less waste at nonprofits, fewer self-interested management choices, less money flowing to inefficient charities, *etc.*)

Even so, the precise effects are not easy to predict. For example, making nonprofits strictly liable for inaccuracy should strengthen their incentive to be accurate, but it also could motivate them to issue less detailed disclosure. As a result, the net impact on the supply of information is unclear.

Instead of offering a detailed proposal to manage these tradeoffs, this Article makes a more fundamental point: the goal of the relevant rules should be to maximize the net benefit from program analyses. In choosing the scope of required disclosure, standard of liability, penalties, and enforcement mechanism, policymakers should strive to maximize the benefits of disclosure, while minimizing the costs of verifying and sharing this information, so total benefits exceed total costs by as wide a margin as possible.

C. Program Analyses for For-Profit Firms

While the focus here is on nonprofits, for-profit firms should also consider disclosing a program analysis if they pursue goals other than profitability. By sharing their goals and strategies, they can reap the same monitoring and other benefits as nonprofits. In fact, state law requires disclosure from a special type of for-profit corporation, the "benefit corporation," which "looks like a standard corporation in almost all respects but one: It is legally obligated to promote the public interest."[174] As with nonprofits, rating agencies can play a useful role in evaluating their

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$500,000 for corporations making false statements under penalty of perjury); I.R.C. § 7207 (providing for a fine up to $50,000 for corporations filing false returns).

[174] Briana Cummings, Note, *Benefit Corporations: How to Enforce a Mandate to Promote the Public Interest*, 112 COLUM. L. REV. 578, 580 (2012). Benefit corporations are available in 36 states. B LAB, *State by State Status of Legislation*, https://benefitcorp.net/policymakers/state-by-state-status. [https://perma.cc/R8KW-LK94] They are required to issue benefit reports. B LAB, *Benefit Corporation Reporting Requirements*, https://benefitcorp.net/businesses/benefit-corporation-reporting-requirements [https://perma.cc/7ELD-H6EZ].

work,[175] and common metrics are needed for comparisons.[176] The costs of preparing disclosure and policing its accuracy should also be comparable, though different regulators are involved.[177]

V. SHOULD DISCLOSURE OF A PROGRAM ANALYSIS BE VOLUNTARY OR MANDATORY?

The last Part analyzed the benefits and costs of disclosing a program analysis. Should each nonprofit weigh these competing considerations and make its own decision? Or should a policy be set for the entire sector? In the for-profit sector, the question of whether disclosure should be mandatory is "[p]robably the most debated issue in securities regulation."[178] Meanwhile, a different literature criticizes other types of mandatory disclosure, arguing that its intended audience does not read it or cannot understand it.[179] Notwithstanding these concerns, this Part recommends that disclosure should be mandatory for large public charities (*e.g.,* with budgets above ten million dollars) and voluntary for other nonprofits. After discussing a nonprofit's incentives to disclose voluntarily, this Part emphasizes gaps in these incentives that justify mandatory disclosure, and then addresses familiar concerns about disclosure requirements.

A. Reports Shared Privately with Specific Donors

Obviously, there is no need to *require* disclosure if nonprofits already share information *voluntarily*. This is true to a certain extent. For example, donors to a private foundation usually can get detailed information about its activities. Likewise, major donors to a public charity usually require reports on how their money was spent and sometimes also on the impact and cost-effectiveness of programs they fund, as noted above.

If every major donor and rating agency negotiates to receive a program analysis — for instance, in a private report sent only to them — they all can be more effective monitors, thereby advancing a key goal of this Article. Admittedly, modest donors might not have the leverage to receive a program analysis, but they are unlikely to be effective monitors anyway. After all, a

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[175] Ben & Jerry's Ice Cream, Stonyfield Organic, and over 3,000 other companies have become "certified B corps." *See B Corp Directory*, B LAB, https://bcorporation.net/directory [https://perma.cc/S5RP-EF8M]. For a discussion of the process, see *How to Become a Benefit Corporation*, B LAB, https://benefitcorp.net/businesses/how-become-benefit-corporation [https://perma.cc/5FKZ-VW6V]

[176] *See* Roy Shapira, *Corporate Philanthropy as Signaling and Co-Optation*, 80 Fordham L. Rev. 1889, 1898 (2012) (describing a "cacophony of indices" for measuring social impact); Brent J. Horton, *How a Uniform Disclosure Regime Would Empower Benefit Corporations*, CLS BLUE SKY BLOG (July 24, 2018), https://clsbluesky.law.columbia.edu/2018/07/24/e [https://perma.cc/A6YR-HD2L] (advocating uniform disclosure for benefit corporations); *see also Toward Common Metrics and Consistent Reporting of Sustainable Value Creation* (World Economic Forum) (Jan. 22, 2020), https://www.weforum.org/whitepapers/toward-common-metrics-and-consistent-reporting-of-sustainable-value-creation [https://perma.cc/MK3W-YV3M] (proposing "a common, core set of metrics and recommended disclosures").

[177] The Securities and Exchange Commission regulates disclosure of public for-profit firms, and the Internal Revenue Service plays no role in their disclosure.

[178] Goshen & Parchomovsky, *supra* note 68, at 755 ("Probably the most debated issue in securities regulation is whether disclosure duties should be mandatory.").

[179] *See generally* Ben-Shahar & Schneider, *supra* note 12; Pozen, *supra* note 12.

donor who lacks the clout to ask for disclosure presumably has little influence on management's choices.

Even so, a report shared selectively is less useful than one shared with the public for a number of reasons. For one thing, managers are likely to take a publicly-disclosed report more seriously. It is visible to the media, potential future employers, peers at other nonprofits, and other audiences that matter personally to managers.

In addition, when managers communicate separately with each donor, they have more latitude to vary the message, telling each donor what she wants to hear. For example, if a donor worries that management is favoring other donors' priorities over her program, she learns less from a report sent only to her, since managers are freer to overstate the importance of her program when addressing her alone.[180] In a report that goes to everyone, by contrast, managers are forced to deliver a consistent message.

Likewise, a document provided only to selected donors obviously is less effective than public disclosure in generating the two other benefits discussed above: better informed donor choices and wider dissemination of innovative ideas. In contrast, public disclosure reaches anyone who might benefit from it, including modest donors, potential donors, and managers of other nonprofits.

B. Public Disclosure Shared Voluntarily

All of these audiences can benefit when a program analysis is posted on a public website, even if this step is not required. One reason to do so voluntarily — at least at a public charity — is to enhance fundraising. A program analysis can make the case "on the merits" for the nonprofit's work. Sharing this information also demonstrates the nonprofit's commitment to transparency and accountability, and its willingness to revisit priorities and hunt for new efficiencies every year. This willingness to share detailed information — and, in effect, to invite more rigorous scrutiny from external stakeholders — is a signal of quality.[181]

Yet managers obviously are less motivated to disclose voluntarily when the news is bad. Facts that cast doubt on the mission's importance or a program's effectiveness do not help fundraising and can tarnish reputations. Needless to say, disclosing this bad news still has significant social value, for instance, in cautioning donors about a nonprofit's ineffectiveness or in allowing other nonprofits to learn from its mistakes. But managers and board members obviously may hesitate to share this information for their own reasons.[182]

[180] *Cf.* Triantis, *supra* note 11, at 1148 ("the philanthropic motives of donors differ somewhat from each other, and this heterogeneity multiplies the axes of agency conflict").
[181] Admittedly, some donors are less interested in data than in emotional appeals. For them, nonprofits can rely on inspiration instead of information. Yet a growing cohort of donors, who focus on impact and efficiency, want an analysis like the one recommended here.
[182] Indeed, one commentator warns foundations to be careful about disclosing "information about not-so-successful outcomes" because it "may give ammunition to those who want to brand the foundation as ineffective." Tyler, *supra* note 60, at 87.

Even so, they might still volunteer bad news for two reasons. First, disclosing bad news strengthens credibility. Second, a lack of disclosure is itself a negative signal. Managers might worry that if they stay silent, others will assume the situation is worse than it actually is. As Easterbrook and Fischel have observed, a firm "must disclose the bad with the good, lest investors assume that the bad is even worse than it is."[183]

C. Rationales for Mandatory Disclosure

So far, this Article has offered a number of reasons to prepare and disclose a program analysis. First, preparing it presses managers to make better decisions. Second, sharing it with board members can improve their oversight. Third, showing it to donors empowers them to be more effective monitors. Fourth, rating agencies can use it to conduct better-informed evaluations. Fifth, sharing a single analysis with everyone — instead of a different report with each major donor — forces managers to be consistent. Sixth, circulating this analysis widely raises the reputational stakes for managers and the board, motivating them to produce better results. Seventh, sharing disclosure with the public enables donors who otherwise would not receive this information to make better-informed decisions. Finally, disseminating this information helps nonprofits borrow ideas from each other.

Given these benefits, nonprofits might choose to share program analyses voluntarily. Yet there are still two reasons to mandate this disclosure, which are considered here in turn. First, when disclosure is voluntary, nonprofits undersupply it. Second, in disclosing voluntarily, nonprofits are free to use varying metrics and methodologies, rendering comparisons more difficult.

1. Voluntary Disclosure is Undersupplied

When not required to share program analyses, nonprofits are likely to undersupply them for three reasons. First, a program analysis is valuable to people who do not pay for it, including philanthropists who decide not to donate, beneficiaries, and other nonprofits that want to borrow innovative ideas. To these stakeholders, a program analysis functions as a public good, which is likely to be undersupplied unless nonprofits are required to offer it.[184]

Second, agency costs can keep a nonprofit from disclosing bad news, even if it is in the organization's interest to do so. For example, managers and board members might choose not to disclose so they can avoid *current* reputational harm and declines in funding, even if the result is *greater* reputational harm and declines in funding *in the future*. This is a rational choice when managers and board members are near the end of their service. Obviously, they cannot make this self-interested choice if disclosure is mandatory.

Third, compared with for-profit firms, nonprofits can offer a more plausible explanation for not providing a program analysis, so their silence is less likely to be construed as a red flag.

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[183] Easterbrook & Fischel, *supra* note 161, at 683.

[184] *Cf.* Coffee, *supra* note 161, at 728 ("[I]f market forces are inadequate to produce the socially optimal supply of research, then a regulatory response may be justified"); Goshen & Parchomovsky, *supra* note 68, at 756 (concluding that information is a public good and "the misalignment between the private and social value of information justifies mandatory disclosure").

Unlike a for-profit firm, a nonprofit can plead poverty. "Every dollar I spend on a program analysis," the head of a soup kitchen might say, "is a dollar I can't spend on feeding clients."[185] This argument often is based on a false economy, as noted above, since the analysis should help a nonprofit run more efficiently and raise more money. But frugality could still be a plausible pretext, which spares nonprofits from issuing disclosure — even when they are, in fact, seeking to conceal bad news.[186]

2. Voluntary Disclosure Is Less Useful

If disclosure is voluntary, there is a risk not only that less information will be disclosed, but also that it will be less useful. If only a subset of nonprofits provide a program analysis, it becomes more difficult to compare those that do with those that do not.

Even among nonprofits that do issue disclosure, comparisons are more difficult if organizations share different information or use inconsistent methodologies, as noted above. With mandatory disclosure, a format can be specified to facilitate comparisons. For example, all nonprofits can be required to answer the three questions, but soup kitchens and orchestras can answer with different types of information. Regulators should be careful not to prescribe the details of what each type of nonprofit should disclose, as noted above.[187] Yet they can nudge the process along, relying on competing nonprofits to vet different methods of sharing information, mediated by funders, rating agencies, and industry groups. Admittedly, a common approach could still emerge if disclosure is voluntary, but some nonprofits might be less willing to participate in this process without a regulatory mandate to do so.

D. Concerns About Mandatory Disclosure

The prior Section offered reasons to require the disclosure recommended here. This Section considers offsetting reasons not to do so. The main downside is cost, at least for small nonprofits. Other familiar criticisms of mandatory disclosure — the risk that no one would read it or that it would crowd out better regulatory alternatives — should not apply in this context.

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[185] *Cf.* Melissa M. Stone & Susan Cutcher-Gershenfeld, *Challenges of Measuring Performance in Nonprofit Organizations*, *in* Measuring Impact, *supra* note 8, at 52, 54 (noting that funders and nonprofit executives interviewed "fear that money spent on evaluating performance was money that would have to be taken away from program delivery").

[186] There is empirical evidence that donors do not always "assume the worst" when nonprofits choose not to issue disclosure. Putnam Barber, Megan Farwell & Brian Galle, Does Mandatory Disclosure Matter? The Case of Nonprofit Fundraising 17 (June 12, 2020), SSRN: https://ssrn.com/abstract=3625800 or http://dx.doi.org/10.2139/ssrn.3625800 [https://perma.cc/6K7G-H5QL] (when charities were required to disclose the ratio of their fundraising costs to their budget, donations declined for nonprofits with high ratios, so donors must not have assumed ratio was high before it was disclosed).

[187] *See supra* Part IV.A.1.

1. Limiting Mandatory Disclosure to Large Public Charities

Notwithstanding the advantages of preparing and disclosing a program analysis, some might consider the cost too high, especially at small nonprofits. This cost should not be overstated even at small nonprofits, since they have less to analyze and discuss, as noted above. Yet there are still fixed costs, including management time, which can represent a meaningful percentage of a small nonprofit's budget.[188] To avoid this expense, some small nonprofits might reasonably decide not to prepare a program analysis.

Yet the calculation is different at large nonprofits. Their scale and complexity make a program analysis more valuable. Admittedly, this complexity may force a large nonprofit to spend more than a small nonprofit to produce a program analysis. However, this expense still is likely to represent a smaller percentage of the large nonprofit's budget, since important components, such as management time, are fixed costs. Compared with small nonprofits, then, large ones are likely to derive more benefit from a program analysis, while incurring a (proportionally) lower cost. As a result, if a large nonprofit "pleads poverty" in declining to provide a program analysis, there is a greater risk that this claim is a pretext to avoid sharing bad news, as noted above.

Given this difference between large and small nonprofits, this Article recommends requiring large nonprofits to disclose a program analysis, while letting small nonprofits choose whether to do so.[189] The cost of this disclosure should not be an issue for nonprofits with an annual budget over ten million dollars, and a lower threshold would be plausible as well.

Among these large nonprofits, the case for requiring public disclosure is stronger for public charities than for private foundations. Foundations should certainly engage in rigorous analysis to decide how to allocate their funds, and many do. But this analysis does not need to be disclosed publicly to reach a private foundation's donors, which (by definition) are a small group. As a result, two of this Article's main justifications for public disclosure — recruiting more donors as monitors and helping donors make better-informed choices — do not apply to private foundations.[190]

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[188] *Cf.* Easterbrook & Fischel, *supra* note 161, at 671 ("Existing rules give larger issuers an edge, because many of the costs of disclosure are the same regardless of the size of the firm or the offering.").

[189] By analogy, nonprofits do not have to file Form 990 if their annual budget is below $200,000. I.R.S. Publication 557, Tax-Exempt Status for Your Organization 11 (Feb. 6, 2020). They file Form 990EZ if their budget is between $50,001 and $200,000, and an e-postcard if their budget is below $50,000. *Id*. As of 2015, approximately 34% of the nation's 1.56 million registered nonprofits file Form 990, Form 990EZ, or Form 990PF (for private foundations). McKeever, *supra* note 2.

[190] Although public disclosure by private foundations would not reach potential donors, it could still reach rating agencies and the media. I thank Henry Hansmann for this observation. Yet the main reason why rating agencies and the media have influence over nonprofits -- their sway with donors -- is absent, or at least muted, in private foundations. Donors to private foundations ordinarily have ample information about their activities. As a result, rating agencies and the media are unlikely to provide a donor with new information, although they can offer a different perspective or highlight something the donor has missed. However, the analysis changes somewhat after the donor has passed away. At this point, the foundation's board has significant autonomy (especially if the heirs are not involved) and might benefit from rigorous feedback from rating agencies and the media; indeed, in setting up a foundation, a donor might choose to require annual disclosure for this reason. *But see* Tyler, *supra* note 60, at 89-91 (highlighting the downsides of disclosure by private foundations, including administrative costs and the awkwardness of explaining why grants were rejected). In principle, rating agencies and the media can also influence private foundations by mobilizing

Admittedly, disclosure from private foundations can add value in other ways. For example, they can share information about innovations, failed experiments, and best practices; again, many already do. In any event, if the disclosure requirement suggested here applies only to public charities with budgets over $10 million, it would reach only 5.3% of public charities, but would still cover 87.7% of the annual spending of all public charities, totaling $1.6 trillion.[191]

2. Will Enough Donors Read This Disclosure?

A familiar criticism of mandatory disclosure is that its intended audience often does not read it or cannot understand it. Because consumers don't have the time or cognitive bandwidth to review the barrage of disclosure they receive every day, Professors Ben-Shahar and Schneider conclude that this disclosure cannot "protect the naïve from the sophisticated."[192]

Yet the main goal of the disclosure proposed here is not to protect unsophisticated consumers, but to empower and recruit sophisticated monitors, including board members, donors who make large gifts, rating agencies, and the media. By improving their monitoring, and thus causing the nonprofit to run more efficiently, this disclosure can indirectly benefit stakeholders who do not read it, including donors who give modestly and the nonprofit's beneficiaries.[193] In other words, this disclosure can still add value even if only a fraction of a relatively small audience reads it.

A program analysis also can inform stakeholders who lack the clout to be effective monitors. It allows modest donors to ensure that a nonprofit's work matches their preferences, while also enabling nonprofit managers to borrow promising ideas from each other more easily. Even though some of these stakeholders will not use this information, others surely will.

3. Will Mandatory Disclosure Crowd Out Better Regulatory Responses?

Another concern about mandatory disclosure, emphasized by Professor Pozen, is that it might "stave off other forms of regulation" that could be more effective.[194] Yet the other regulatory options are somewhat limited in this context. The I.R.S. and the state AG lack the expertise to

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regulators, but substantive oversight from the government poses complex tradeoffs, as discussed above. *See supra* Part II.B.

[191] Of 1.09 million public charities in 2015, only 16,556 (or 5.3 percent) had budgets of ten million dollars or more, but those with budgets in excess of ten million dollars spent $1.6 trillion, representing 87.7 percent of all spending by public charities. McKeever, *supra* note 2.

[192] Ben-Shahar & Schneider, *supra* note 12, at 649, 705-08 (using stylized example of "Chris Consumer" to show the impossibility of actually reading and absorbing all mandated disclosures).

[193] *Cf.* Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630, 638 (1979) ("The presence of at least some consumer search in a market creates the possibility of a 'pecuniary externality': persons who search sometimes protect nonsearchers from overreaching firms."); Ben-Shahar & Schneider, *supra* note 12, at 748 ("Insofar as disclosure causes disclosers to behave better . . . , disclosees need not rely on the disclosed data but can instead (as they say) shop with confidence").

[194] Pozen, *supra* note 12, at 162; *see also* Ben-Shahar & Schneider, *supra* note 12, at 740 ("[L]awmakers who devised disclosure mandates may think their mission accomplished and avoid the onerous work of devising more imaginative, more effective alternatives").

engage in substantive oversight of nonprofit programs in many cases, as noted above, and could undermine nonprofit independence in playing this role.[195]

If the government set aside these concerns and decided to engage in substantive oversight, regulators would need information. To assess the social value of a nonprofit's mission and the impact and cost-effectiveness of its programs, regulators would need something like the program analysis recommended here. So if the government wants to review the substance of nonprofits' work, disclosure would not be a distraction from this effort, but a precondition for it.

VI. CONCLUSION

Unfortunately, some nonprofits waste money on dated missions and inefficient programs. This Article breaks new ground in attributing this inefficiency not just to imperfect incentives, but also to imperfect information. Challenges in measuring success complicate the efforts of even the best managers and boards to run nonprofits efficiently. These measurement challenges also make self-interested and unwise choices less visible, and thus harder to stop.

In response, this Article recommends better analysis and disclosure as a strategy for organizational change. As a template for this analysis, this Article recommends three questions for nonprofits to answer every year: first, how important are the challenges they address?; second, how effective are their responses?; and third, are they the right nonprofit to respond? This sort of analysis presses managers and boards to clarify priorities, monitor progress, improve even their best programs, and shut down ineffective ones.

Nonprofits should also share this analysis with the public. This disclosure empowers boards, donors, and rating agencies to be more effective monitors, enables donors to make better informed philanthropic choices, and allows charities to borrow innovative ideas from each other more easily. Admittedly, these benefits are not free. Difficult issues must be analyzed and the accuracy of disclosure must be policed. To balance these competing considerations, this Article recommends that this disclosure should be mandatory for large public charities and voluntary for other nonprofits. Admittedly, analysis and disclosure are not foolproof remedies. At the margin, though, this effort can press nonprofits to operate more efficiently, so they touch more lives and do more good in the world.

[195] *See supra* Part II.B.