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Abstract:

In the United States, the 501(c)3 public charity is the dominant institutional form for philanthropic activity. However, the emergence of new innovations in philanthropic forms and instruments suggest certain limitations to the traditional form of the public charity, specifically as a vehicle for outcome-oriented philanthropy. In line with recent calls to reexamine the fundamental precepts and conventional wisdoms of nonprofit studies, this article critically analyzes the institutional form of the public charity and the 'standard theory' that describes it. This analysis demonstrates that the form of the public charity, including the current legal and cultural architectures in which it is embedded, are implicitly designed to maximize resource provider satisfaction and that this objective is necessarily incompatible with the maximization of program outcomes. In this 'iron circle' model, donors and nonprofits provide mutual benefits to one another, disregarding beneficiary welfare, and no reliable selection mechanism exists in the sector that could possibly promote allocative efficiency. Further analysis attributes this scenario to the role of information costs and the 'specter of disappointment.' Although reform is extremely unlikely, policy implications suggest specific means of developing an information ecosystem significantly more conducive to outcome-oriented philanthropy and the solving of the social problems evidently delegated to the nonprofit sector.

Outcome-Oriented Philanthropy and the Problem of Institutional Design

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

In light of recent calls to reexamine conventional wisdoms in the field of nonprofit studies (Mitchell, 2014, 2017b, 2018; Mitchell & Calabrese, 2018), this article critically analyzes the institutional form of the modern public charity and reconsiders the 'standard theory' of the nonprofit as developed in the late 1970s and early 1980s and persisting largely intact to date. Specifically, this analysis reveals that the implied objective function of the public charity, inclusive of its regulatory and cultural architectures, is the maximization of resource provider satisfaction. Analysis also demonstrates that this function is incompatible with the maximization of program outcomes. This guarantees inefficiency in the production of outcomes relative to an alternative institutional design scenario in which certain information costs are defrayed and distributed across an outcome-oriented philanthropic ecosystem.

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

The purpose of nonprofits

Nonprofit theory is complicated by the extreme heterogeneity within the sector. Scholars have long recognized that nonprofits (specifically, public charities) exist to serve a variety of purposes in society. Under section 501(c)3 of the United States Internal Revenue Code (IRC), for example, acceptable charitable purposes for nonprofits include "religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition…, or for the prevention of cruelty to children or animals." The US Internal Revenue Service (IRS), which administers the IRC, has issued additional guidance, stating that:

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

The National Taxonomy of Exempt Entities (NTEE) recognizes dozens of categories of nonprofit organization, including ‘fee-for-service’ reliant hospitals and universities that consistently rank among the largest public charities in the country. Although certain categories of nonprofit are subject to different regulatory requirements, they all generally operate under the same basic legal and cultural architectures described by the ‘standard theory’ of the nonprofit (discussed below).

The NTEE classifications notwithstanding, others have expressed broader theory-based distinctions between different types of nonprofit, or viewed differently, between different dimensions of a given nonprofit’s purpose or function. Specifically, nonprofits instantiate both expressive and instrumental purposes or dimensions of philanthropy (Frumkin, 2002; C. W. Gordon & Babchuk, 1959; Mitchell, 2018). Expressive philanthropy often involves traditional almsgiving, in which virtue is manifested in the act of giving itself, or it may generally involve the fulfillment of the psychological or sociological needs or desires of donors to conform to social norms, claim membership in a community, or experience private emotional benefits, such as a ‘warm glow’ feeling that they are ‘doing good.’ By contrast, ‘instrumental, ‘outcome-oriented,’ or ‘strategic philanthropy’ aims at demonstrable goal achievement. This is philanthropic activity in which “donors articulate and seek to achieve clearly defined goals; they and/or their grantees explore and then pursue evidence-based strategies for achieving those goals; and both parties monitor progress toward outcomes and assess success in achieving them in order to make appropriate course corrections” (Brest, 2015).

The current legal framework and institutional form of the public charity in the United States is path dependent, predominantly having emerged from traditions of religious almsgiving, missionary activity, and charitable paternalism attendant to expressive philanthropy (Hall, 2010). As society and the economy evolved over time, notions of a charitable sector expanded to include other activities loosely contributing to public welfare and “lessening the burdens of government” (IRS, 2018). Over the course of the twentieth century, the legal framework of the nonprofit concomitantly evolved to accommodate these changes, to effectually expand the legal definition of nonprofit, and to deliberately encourage philanthropy through tax expenditures (Arnsberger, Ludlum, Riley, & Stanton, 2008). In light of this historical evolution, the emergence of outcome-oriented philanthropy *per se* is a relatively recent development that the inherited US legal architecture for nonprofits was never really designed to specifically facilitate.

Given the basic distinction between expressive and instrumental philanthropic purposes and the possibility of their being distinct institutional forms optimized for each purpose, a nonprofit sector might theoretically be comprised of organizations designed and regulated to optimize one of two alternative objective functions. In the first type of sector, nonprofits could be designed to maximize resource provider satisfaction by catering to the expressive needs of philanthropists. This type of nonprofit sector exists to provide maximum utility to the donor. In the second type of sector, nonprofits maximize program outcomes by serving the needs of program beneficiaries. Analysis demonstrates that both objective functions cannot be optimized simultaneously because the observation required for outcome-oriented philanthropy is costly in terms of a 'specter of disappointment' that necessarily reduces expected donor utility in expressive philanthropy.

Maximizing resource provider satisfaction

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

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

However, the nondistribution constraint also imposes a negative side effect. If nonprofit practitioners cannot retain net earnings for private benefit, then they have a reduced incentive to minimize costs. As such, "inefficiency is inherently embedded in nonprofit services" (Kim & Kim, 2016, p. 2942). Performance cannot be measured or rewarded, which incentivizes shirking and decouples a nonprofit's financial performance from its mission performance. Moreover, given legal requirements and cultural norms that effectually suppress nonprofit salaries relative to other sectors,[4] nonprofit employees, being unable to increase their salaries, can only improve their effective wages by reducing their work effort, and implicitly, forgoing opportunities to maximize program outcomes. In principle, a nonprofit could persist indefinitely simply by satisfying resource providers and without ever advancing its mission through the achievement of meaningful program outcomes (Moore, 2000). Additionally, reputation effects cannot be relied upon to police efficiency in the production of program outcomes. Reputation cannot be a function of outcome achievement because outcomes are unobservable. In the ecology of the nonprofit sector there is no reliable exit mechanism for removing low-performing organizations on the basis of effective or efficient outcome attainment.

Moreover, the non-observing of outcomes is necessary for maximizing resource provider satisfaction, assuming that resource providers are averse to disappointment. Under an alternative scenario of perfect information, donors would face the risk of being exposed to disappointing information when nonprofits fail to achieve the desired program outcomes. However, if nonprofit outcomes are never observed, or if outcome information is selectively suppressed or tendentiously manipulated, then resource providers have no risk of disappointment. Thus ‘strategic ignorance’ is rational and satisfaction-maximizing (Pritchett, 2002) because it licenses wishful thinking. Optimistic beliefs about nonprofit outcomes cannot possibly be falsified, guaranteeing that resource providers experience a ‘warm glow’ in exchange for their contributions (Andreoni, 1990; Crumpler & Grossman, 2008; Null, 2011). Organizational trustworthiness lends plausibility to the assumption that charitable contributions necessarily lead to desirable outcomes, absent explicit and credible evidence to the contrary.

Indeed, the warm glow-strategic ignorance framework has significant theoretical and empirical evidence on its side. ‘Informed giving’ appears to be exceedingly rare (Krasteva & Yildirim, 2013, 2016) and givers appear to be averse to paying for information that would allow them to make more informed decisions (Null, 2011). Moreover, experiments in behavioral economics reveal that donors will contribute to nonprofits even under the complete certainty that their contributions will have absolutely no impact (Crumpler & Grossman, 2008).

[Insert Figure 1 about here.]

Nonprofits are essentially in the business of selling licenses to 'feel good' to resource providers. In this sense there is no information asymmetry because the resource provider is also the recipient of the license.[5] The quality of the license is proportional to the credibility and trustworthiness of the nonprofit and the imagination of the resource provider. Figure 1 illustrates the cycle of resource provider satisfaction. The actual attainment of nonprofit outcomes is unnecessary and incidental. The cycle can persist indefinitely even if outcomes are never obtained or are fundamentally unattainable. In Seibel's (1996) interpretation, for instance, society specifically delegates unsolvable problems to nonprofits to alleviate social anxiety by concealing problem unsolvability. Observing outcomes would not only be self-defeating by exposing donors to disappointment, but it would actually contravene donor intent.

Management implications

The principal tasks of the nonprofit manager in this scenario are (1) to strategically protect resource providers from unwanted information while (2) maintaining organizational trustworthiness for the licensure of wishful thinking. The former can be achieved simply by not observing outcomes and by avoiding negative publicity and appearances of impropriety. Nonprofits can claim that outcomes are too difficult, costly, or distortive to measure, that evaluation is unnecessary, or that evaluation would divert resources away from other priorities, for example. Indeed, credible evaluation is extremely rare in the sector (Mitchell & Berlan, 2016). Nonprofits can also produce suggestive reports and materials that tendentiously portray their efforts in the best possible light. Psychologically motivated resource providers will interpret such information as confirmation that their wishful thinking is warranted.

The latter problem of trustworthiness is addressed through financial disclosure and surveillance. Nonprofit information intermediaries, 'infomediaries,' or 'watchdogs' rigorously monitor nonprofits' financial records and provide ratings, rankings, or other designations intended to inform donors. Generally, nonprofit trustworthiness is operationalized as the proportion of a nonprofit's total functional expenses classified as 'program spending' in a given fiscal year (Mitchell, 2018; Mitchell & Calabrese, 2018). The program expense ratio (or conversely, the overhead ratio) is commonly used in such evaluations (for example, by organizations such as Charity Navigator, the Better Business Bureau Wise Giving Alliance, Christian Science Monitor, Forbes Magazine, Charity Watch, and many others). Other common indicators include (inversely) executive compensation, the cost to raise marginal dollar from donors, and reserve and debt ratios. None of this surveillance systematically accounts for program outcomes.

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

Critically, it is not necessary to monitor or achieve program outcomes to be trustworthy or desirable to resource providers in this scenario. To the contrary, if outcome achievement is credibly disclosed donors may be disappointed to discover that the actual outcomes achieved fail to meet their expectations, or donors may interpret the achievement of outcomes as indicative of insufficient need for further contributions (Charles & Kim, 2016). Moreover, when the imperative to appear trustworthy conflicts with the maximization of program outcomes, managers face strong incentives to sacrifice outcomes in favor of reporting desirable financial indicators that signal trustworthiness. After all, financial indicators are observed but outcome information is not (Mitchell, 2018). The cultural accountability architecture of the 501(c)3 public charity construes financial costs other than immediate program expenditures as theoretically available for 'opportunistic' misappropriation and embezzlement, which signals untrustworthiness, regardless of outcomes.[6]

Societal implications

Non-observing outcomes eliminate the risk of unwanted information and thereby improves risk-adjusted resource provider satisfaction, but it also means that the philanthropic 'marketplace' cannot possibly have the information necessary to efficiently allocate resources across nonprofits because outcomes cannot be priced (Mitchell, 2014).[7] That is, there must exist superior allocations of resources that would improve the aggregate outcomes of the nonprofit sector holding total available resources constant. However, these allocations are fundamentally undiscoverable because outcomes are not observed. Indeed, observing them would reduce aggregate risk-adjusted donor satisfaction. Non-observation essentially eliminates observation costs and removes the 'specter of disappointment,' but it is not costless. One important category of cost is in the form of forgone outcomes.

In this scenario, organizational survival is equivalent to organizational success because continued survival indicates that resource providers value the organization's licensures. The nonprofit sector is essentially a marketplace for licensures rather than outcomes. The price of a licensure depends upon the donor's expected level of satisfaction or utility, which is itself a function of perceived licensure quality. Expected donor satisfaction depends negatively upon the probability of observing disappointing information and increases with licensure quality with diminishing returns. Licensure quality may be influenced by such factors as the perceived reputation of an organization, signals of its trustworthiness such as may be indicated by watchdog ratings, seals of approval, and financial benchmarks, the persuasiveness of its emotional appeals and communications materials, and its general ability to successfully suppress disappointing information while touting success stories that warrant wishful thinking. Licensure pricing cannot depend on outcomes because outcomes are not observed. The result is a nonprofit sector that maximizes resource provider satisfaction regardless of program outcomes.

Some problems with the standard theory

The standard theory of the nonprofit assumes that outcomes are either (1) unobservable in principle or (2) are too costly to observe relative to the benefits. In the first case, outcomes may be unobservable axiomatically or by definition. Remarkably, the axiomatic interpretation requires that the statement 'nonprofits make no observable difference in the world' be true. Yet, at face value this would seem to run counter to the spirit of much of the nonprofit sector as well as the stated intentions of many philanthropists and nonprofit practitioners. More plausibly, denying the possibility of outcome observation serves as a convenient analytical device for excusing ignorance and diverting attention to the relatively more tractable problem of signaling trustworthiness. After all, credibly evaluating outcomes is costly, risky, and potentially self-defeating, as described above.

Another problem with the unobservable outcomes axiom is that it represents a rather strong metaphysical assertion with no inherent justification or reasonably acceptable ontological or epistemological interpretation. For example, are ‘unobservable outcomes’ to be regarded as ‘real?’ If so, what is the nature of their existence? What would be the difference between an unobservable outcome and no outcome at all? Surely stakeholders engaging with the nonprofit sector believe that outcomes are real, and if they are real then they must be observable in principle, whether directly or indirectly.

Academic research has accommodated this problem by construing organizational effectiveness not as an objective condition based on nonprofit outcomes, but rather as a subjective, reputational construct (Mitchell, 2015; Mitchell & Stroup, 2016; Willems, Jegers, & Faulk, 2015) that is socially constructed by multiple stakeholder groups (Herman & Renz, 1997, 1999, 2008) and so is therefore not “a real property” of organizations (Herman & Renz, 1997, p. 188). Although not called out as such in the literature, the socially constructed, ‘unreal’ quality of organizational effectiveness is presumably the consequence of the empirical absence of outcome information. In lieu of such information, organizational effectiveness judgments cannot possibly be based on the achievement of program outcomes, but must be presumed or imagined behind a veil of ignorance. This may not necessarily be a problem for the standard theory *per se*, but only if stakeholders are comfortable accepting that nonprofit organizations literally make no ‘real’ or observable difference in the world and that they exist largely by virtue of their socially constructed reputations—emphatically not because of any ‘real’ progress that they achieve toward their missions. This could be legally problematic, however, depending upon whether the social construction of effectiveness reputation genuinely constitutes a tax-exempt ‘charitable purpose’ in the context of IRC Section 501(c)3. Arguably, the standard theory is at variance with not only commonsense assumptions about the purpose of nonprofits producing real outcomes, but also with the spirit of federal law.

Moreover, defining nonprofits as those entities that specialize in the production of unobservable, non-contractible outcomes is manifestly contradicted by the extensive contracting that is commonplace throughout the sector. Nonprofits routinely enter into and satisfy formal contracts. Either the parties to these transactions are all in error or 'contract failure' theory is falsified or at least requires significant scope conditions.

In the second case, 'distortion costs' emerge as a profoundly important factor not only for the standard theory of the nonprofit but also for strategic management and the fundamental viability of outcome-oriented philanthropy. If nonprofit outcomes necessarily cannot be measured without distortion costs, then the problem would seem to be one of minimizing those distortion effects. For example, nonprofit practitioners could be trained in performance management and program evaluation, and generally accepted principles could be developed to standardize various approaches to outcome accounting analogous to Generally Accepted Accounting Practices (GAAP) for financial accounting. Distortion effects and other costs could be further mitigated by allowing nonprofits to select their own measures and methods and to disclose their outcome information to multiple stakeholders in a standardized format (Mitchell, 2013, 2014, 2017a).

It is not clear why the presence of positive distortion costs should virtually prevent outcome observation in the tax-exempt nonprofit sector, but not in any other sector, although the imperatives of 'strategic ignorance' discussed above provide a possible explanation. In any case, the presence of positive information costs, whether from distortions or from other sources, does not necessarily require that measurement be abandoned. Not measuring also has costs, such as in terms of reduced performance, allocative inefficiency, and in many other ways described in the next section, and it is far from obvious that the optimal amount of measurement is effectually zero for the typical nonprofit. Moreover, the costs of signaling trustworthiness under the alternative arrangement are also positive, particularly in terms of forgone outcomes, which would be particularly concerning if the primary purpose of nonprofits is indeed to produce outcomes (Mitchell, 2018). Additionally, nonprofits also may incur signaling costs to comply with voluntary codes of conduct and ‘accountability club’ standards to elicit trust when informational scarcities or asymmetries exist between resource providers (as principals) and nonprofits (as agents) (Gugerty & Prakash, 2010; Prakash & Gugerty, 2010; Tremblay-Boire, Prakash, & Gugerty, 2016).[8]

The only logically consistent interpretation of the standard theory is that nonprofits exist to maximize resource provider satisfaction, a key condition for which is the *necessary* non-observation of outcomes. Organizational trustworthiness is the critical attribute that warrants wishful thinking and maximizes risk-adjusted resource provider satisfaction when strategic ignorance is rational. Arguably, under the 501(c)3 public charity framework it is the duty of nonprofit managers to prevent the emergence of credible evidence about outcomes to protect donors from the specter (and reality) of disappointment. In short, the public charity is optimized for ‘expressive,’ rather than ‘instrumental’ philanthropy. Its design features maximize resource provider satisfaction, as donors can hardly experience anything but satisfaction if disappointing evidence can never emerge and their wishful thinking will be warranted by organizational trustworthiness. Nonprofits need only to avoid public scandal, which should not be too difficult. The attainment of outcomes is theoretically incidental to the design features of the public charity. This may reasonably reflect the historical origins of philanthropy in religious almsgiving but does not efficiently serve the needs of outcome-oriented philanthropists today.

Maximizing program outcomes: The problem of information costs

‘Outcome-oriented’ philanthropy involves strategic giving for the explicit purposes of achieving and maximizing program outcomes (Brest, 2012). Theoretically, outcome-oriented philanthropists seek to maximize outcomes per dollar, and thus require information about outcomes and their unit costs.

Because outcome-oriented philanthropists are outcome-maximizing, they will always prefer resource allocations that correspond with higher levels of aggregate outcomes, given their preferences and mission valence.[9] Their philanthropic activity is 'instrumental,' rather than 'expressive' and represents a strategic, goal-directed, evidence-based approach to problem-solving.

Although outcome-oriented philanthropy represents only a small fraction of giving in the US, its potential is considerable. According to a widely-cited industry study, about sixteen percent of surveyed philanthropists appear to have an outcome-orientation. Moreover, as much as $45 billion in annual charitable contributions may be 'switchable' in that the contributions could potentially be directed on the basis of outcomes (Hope Consulting, 2010). Other estimates have placed the total potential size of an outcome-oriented philanthropic marketplace at about $116 billion (Mitchell, 2014) and an impact investment marketplace at around $120 billion (Hope Consulting, 2010).

Assuming that social problems are solvable and that nonprofit outcomes are 'real,' then attention turns to the problems of mitigating and defraying information costs. Weisbrod and Schlesinger (1986) imply that 'distortion costs' will generally make outcome measurement counterproductive because the distortions resulting from poor measurement will outweigh the benefits of higher performance. However, this implication relies on the assumption that nonprofit outcomes invariably have unobservable components regarding which measurement must necessarily be poor or impossible. This requires that at least some significant component of nonprofit outcomes is necessarily unobservable, *even in principle*, as according to the standard theory this unobservability is the reason why a nonprofit sector exists at all. Distortion costs arise, in other words, because nonprofit outcomes are 'not real' either in whole or in part. 'Not real' means that there is no possible means of distinguishing between such outcomes (or their components) and nothing at all.

Distortion costs are more reasonably the result of poor measurement rather than a corollary of the fundamental observability or 'unrealness' of all or part of nonprofit outcomes. This is an important distinction because poor measurement can be improved, whereas fundamentally unreal things cannot also be real. Instead, distortion costs appear to be of the 'teaching to the test' variety, in which case one obvious means of mitigating such costs would not necessarily be to abandon measurement altogether but rather to construct better tests—to carry the metaphor. Unfortunately, creating better tests is costly and effortful, whereas axiomatically excusing non-measurement is essentially costless and effortless. Moreover, it conveniently serves the purposes illustrated in Figure 1 by eliminating the specter of disappointment. There are no aggrieved parties to the transaction to issue protest, as donors receive licensure and nonprofits receive resources. Potential program beneficiaries are not party.

Distortion costs are distinct from the direct financial costs of measurement and evaluation. 'Evaluation costs' include not only direct financial costs but also costs in terms of time, technical expertise, and administrative infrastructure or overhead (that is, investments that make evaluation even possible). Nonprofits typically have great difficulty funding evaluation costs and related investments because resource providers tend to interpret such expenditures as diversions of resources away from current programs indicative of untrustworthiness. Indeed, nonprofits with higher evaluation costs relative to direct program expenses would generally be expected to see reduced contributions through the mechanism of overhead surveillance discussed above. Although evaluating programs and therefore incurring evaluation costs would presumably contribute to superior outcomes over time, such nonprofits would ironically be put at a significant disadvantage in the current 501(c)3 environment because resource providers will observe the resultant signals of untrustworthiness but cannot observe the superior outcomes.

Nonprofits that do measure and evaluate outcomes must also have a means of usefully disclosing that information to resource providers and to the public generally. 'Disclosure costs' can also be significant for nonprofits, as they may require organizations to create and maintain systems not only for outcome accounting but also for reporting that information in a manner that external stakeholders can understand. Many nonprofits already produce costly annual reports, but these generally lack credibility because any outcome claims they may contain are virtually never audited and these outcomes are not part of any current accounting regime. Outcome-oriented philanthropists cannot trust that any outcome information contained within the reports is accurate or if, for instance, unfavorable information has been manipulated, misreported, or suppressed. Although nonprofits respecting the nondistribution constraint may be trusted to be not embezzling, merely not embezzling is not the same as spending money on programs that actually achieve the intended outcomes. A positive amount of direct 'non-opportunistic' spending may be wasted on programs that achieve little or nothing. However, without meaningful outcome accounting and credible disclosure, all direct program spending is entirely undifferentiated and unaccounted for.

The credibility problem is substantial, with a virtually negligible proportion of nonprofits subjecting any outcome information they may have generated for external audit. Outcome auditing is almost unheard of in the nonprofit sector, although there are a handful of relatively small organizations in the US that have begun to offer services along these lines.[10] Thus, in an outcome-oriented philanthropic marketplace 'auditing costs' could be significant to ensure the credibility of nonprofit outcome disclosures. While the nondistribution constraint may help to prevent 'excessive' private inurement and benefit, it does nothing to ensure that non-opportunistic expenditures are spent efficaciously. The sorting function of the nondistribution constraint may tend to disproportionately attract people who are genuinely committed to the mission, but it does not guarantee their competence.

To summarize, nonprofits in an outcome-oriented philanthropic marketplace must mitigate or defray at least four categories of 'supply-side' information costs: (1) distortion costs, (2) evaluation costs, (3) disclosure costs, and (4) auditing costs. These costs are internal to the nonprofit, although obviously for most nonprofits the financial costs must ultimately be supported by external resource providers.

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

Search and discovery costs include a philanthropist’s costs to identify relevant nonprofits and to obtain information about their outcomes and corresponding unit costs. As there is currently no sectoral infrastructure to facilitate this, the philanthropist’s costs are extremely high and search and discovery is relatively haphazard. For example, outcome-oriented philanthropists may resort to personal contacts, word of mouth, and internet searches. Even after relevant organizations are identified, it is unlikely that the philanthropist would be able to obtain relevant information about outcomes or their unit costs ex ante, at least not without a substantial (and probably preclusive) investment to generate the necessary information.

While the time and cost involved to obtain sufficient outcome information for a single nonprofit is likely to be substantial, the aggregate cost to obtain that information for anything close to the entire population of relevant nonprofits is almost certainly prohibitive. Obtaining such information would likely require a philanthropist to independently contract with every relevant organization, to cover the supply-side costs for each nonprofit, and to wait years—or perhaps indefinitely—for information to be generated. The difficulty for an individual philanthropist to extract comparable information from potentially tens of thousands of individual nonprofits is clearly extreme and prohibitive. Instead, the philanthropist would likely choose from an arbitrarily reduced subset of organizations to make the decision more tractable, but even then information costs are extremely high, and ultimately, superior resource allocations will almost certainly exist undiscovered, meaning that outcomes are unlikely to be maximized.

Even if a philanthropist restricts decision making only to an arbitrarily reduced subset of identified nonprofits, the available information would almost certainly be unstandardized and difficult to compare, as the sector lacks accounting or disclosure standards for nonprofit outcomes.[11] The costs of bargaining and decision making are also therefore likely to be extreme, particularly as evidence credibility would also be highly uncertain and require significant effort to ascertain. Information intermediaries would clearly have an important role to play in an outcome-oriented philanthropic marketplace to process information and facilitate comparisons and donor decision making (Ruff, 2013; Ruff & Olsen, 2016).

Finally, surveillance and enforcement on the basis of outcomes is virtually impossible at the sectoral or marketplace level, and is only likely to be meaningful in the context of a specific grant or contract in which the donor has direct oversight over a specific nonprofit for the provision of specific outcomes. Each donor-nonprofit dyad therefore requires a unique contract and virtually line-of-sight oversight for effective surveillance and enforcement. At the sectoral level, the aggregate costs of such mechanisms are enormous. At the level of the philanthropist, the costs are functionally prohibitive for all but the most sophisticated, committed, and resourceful outcome-oriented resource providers, such as large foundations and government funders. Moreover, given the high initial costs of discovering, bargaining, and establishing individual relationships with arbitrarily shortlisted nonprofits, dyads will be 'sticky' because the parties will seek to economize on already-incurred discovery costs. This increases the likelihood that philanthropists will never discover other nonprofits that they would prefer to support if identified. Both supply and demand side information costs obviously represent a significant barrier to outcome-oriented philanthropy and the maximization of aggregate social outcomes.[12]

Discussion and policy implications

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

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

However, since the FASB began discussions about service efforts and accomplishments in the 1970s, little if any progress on this point has occurred. Due to this impasse, a legitimate question is whether the FASB is the correct accounting standard-setter for nonprofits.[13] While financial indicators are important for the financial viability of nonprofits, they are not the primary reason that nonprofits exist, nor should they be the principal basis for informing resource provider decision-making. Hence, accounting standards that do not focus on specific nonprofit outcomes cannot truly inform "rational decisions about the allocation of resources to those organizations" (FASB, 1980). As such, it is surprising that the nonprofit sector—unlike the public sector, which has the Governmental Accounting Standards Board—lacks its own standard-setter to issue best practices for nonprofit outcome accounting. As posed nearly 30 years ago, "Are not-for-profit organizations truly so different from for-profit entities that we need additional elements and quite a different financial reporting system? They are indeed" (Mautz, 1989).

One potential solution to the outcome accounting problem could be to allocate the total expenses of an organization across program goals and outcomes analogously to how nonprofits are currently required to allocate their total expenses across functional expense categories (comprised of programs, management and general, and fundraising). The current reporting model based on functional expense accounting, rather than outcome accounting, operationalizes an expressive philanthropic architecture focused on surveilling organizational trustworthiness to the exclusion of outcomes. Outcome-oriented philanthropists would have little reason to care about functional expense ratios as they take absolutely no account of outcomes or outcome unit costs.[14]

The current IRS Form 990, which is the principal disclosure mechanism for public charities in the US (requiring the functional expense disclosures discussed above), does contain a Statement of Program Service Accomplishments (Part III). However, the IRS provides little meaningful oversight over the Form 990's accuracy (Keating & Frumkin, 2003), and because program service information is not part of a financial reporting regime, the data provided in this section are, by definition, not audited. Including outcome reporting as part of the existing financial reporting regime could improve the quality of information already reported to the IRS. Part III could require nonprofits to allocate all of their total expenses across all of their program service accomplishments, but for this reporting to be meaningful and credible it would need to be informed by agreed-upon accounting standards and audited by bodies with appropriate competence to review outcome information. Neither the standards nor the bodies currently exist.

Additionally, whether a single set of accounting standards can address the diversity of the nonprofit sector is a valid concern. The current financial reporting model focusing on signaling trustworthiness intersects an extremely heterogeneous population of organizations with very different purposes and financial models. As noted above, large hospitals and universities and other nonprofits that derive significant earned income operate in the same accounting environment as local human service organizations that rely on volunteer labor and donations. Part of the difficulty of developing nonprofit accounting standards stems from the extraordinary diversity of entities that are subject to

Section 501(c)3. Introducing separate legal designations that subject different types of nonprofit to different regulatory architectures could make nonprofit accounting standards considerably more useful. At a more basic level, separate legal architectures could be developed for expressive and instrumental philanthropic sectors, with the existing system continuing to serve expressive philanthropy largely unchanged and a new architecture to be put into place for instrumental or outcome-oriented philanthropy. Alternatively, private philanthropists could pool funding into a private 'marketplace' for which funding eligibility would be contingent upon meeting enhanced outcome disclosure requirements.

However, the likelihood for reform is extremely low. Nonprofits have little incentive to break from a regulatory architecture that guarantee them such advantageous financial benefits with so little risk, and donors stand only to lose by exposing themselves to the specter of disappointment. Virtually any departure from the status quo would expose nonprofits and donors to more risk and burden. The cycle depicted in Figure 1 is an iron circle that provides obvious mutual benefits to the relevant parties. Only beneficiary welfare and the social good are disregarded.

Conclusion

By the 1980s economists had begun to ask the fundamental question as to why nonprofits exist in the first place when for-profits could presumably accomplish what nonprofits seek to accomplish without the need for another institutional form. According to the standard theory that emerged from this work more than 30 years ago, nonprofits exist because they are more trustworthy than for-profits in the production of unobservable outcomes. If the reason for unobservability is information costs, then government, resource providers, and even academics and practitioners could seek to mitigate those costs through public policy, funding, and innovations in evaluation, accounting, and related areas respectively. If, however, nonprofit outcomes are unobservable because they are not real, then nonprofits make no difference in the world and do not have a compelling justification for their favorable tax treatment.

There are however at least two other explanations for the existence of nonprofit organizations that merit consideration. First, as explained above, producing outcomes may simply not be the purpose of nonprofit activity, particularly considering the predominance of expressive philanthropy, the phenomenon of uniformed giving, and substantial evidence favoring warm-glow egoism. To put it bluntly, the current philanthropic environment in the US is virtually indistinguishable from one in which the purpose of philanthropy is simply to produce resource provider satisfaction, and without regard for the impact of philanthropic activity on beneficiary welfare.

Second, the nonprofit institutional form has another obvious advantage over the for-profit form to explain its continued existence, which is seldom explicitly acknowledged in this context. The public charity is extremely tax-advantaged. Public charities in the US are exempt from federal income taxes, can receive tax deductible contributions, and are usually exempt from many other forms of taxation at multiple levels of government. Moreover, the IRS exercises considerably less oversight of nonprofits compared to for-profits.[15] This alone may explain why nonprofits have appeared in so many different domains of economic activity, including domains where for-profits already exist. Nonprofits may have a notable comparative advantage in trustworthiness, but not having to pay taxes also has its advantages.

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

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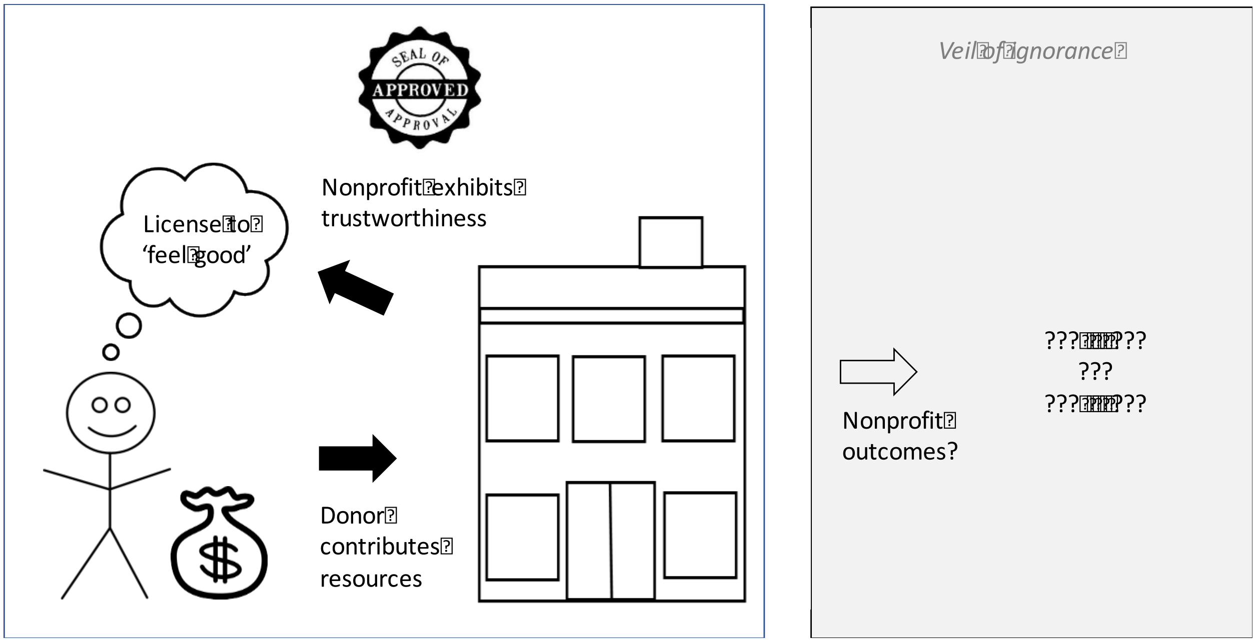
Figure 1: Resource provider satisfaction



Notes

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[1] The term 'nonprofit' is used to refer to the modal type of 'public charity' as indicated by Internal Revenue Service Form 990 records. This definition emphasizes human service nonprofits (the statistical mode) and excludes hospitals and universities, for example.

[2] See, for example: (Mitchell & Calabrese, 2018). Additionally, related innovations in instrumentation also abound, as with the use of social impact bonds and various 'Pay for Performance,' 'Pay for Success,' and 'Payment by Results' schemes, for example.

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

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

[5] In all likelihood neither the nonprofit nor the donor has credible information about program outcomes, so the problem is closer to one of information scarcity rather than asymmetry. Research finds that rigorous program evaluation in the nonprofit sector is exceedingly rare. See, for example: (Mitchell & Berlan, 2016).

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

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

[8] The discourse of information asymmetries generally assumes that nonprofits have information that resource providers lack. However, when all stakeholders lack information it is more accurately a problem of information scarcity.

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

[10] For example, see: https://www.impactm.org/.

[11] A few nascent attempts at standardized disclosure exist. For example, GuideStar enables nonprofits to voluntarily self-report outcomes using their 'Platinum" platform. See: https://learn.guidestar.org/platinum.

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

[13] Further, the FASB lacks enforcement mechanisms for firms that violate GAAP. In the private sector, the Securities and Exchange Commission (SEC) enforces accounting and disclosure requirements, and the benefits of compliance (raising debt and equity from investors efficiently) far exceed the costs of this compliance.

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

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