SECTION ONE

Philanthropy and the Economy

INTRODUCTION TO THE ISSUES

Knowledge, it is said, can be dangerous. Illusory knowledge is more dangerous still. Thinking we know something basic when, in fact, we do not can lead to errors of assumption and of conclusion. Such errors then give rise to failures of judgment about everything from national policy to local accountability.

The philanthropic sector is a case in point. Much philanthropy is formal, emanating from concrete organizations like foundations and corporations. Much, however, is informal, emanating spontaneously from our collective wallets. The former can be measured, at least in theory. The latter often cannot.

If we ignore context, this failure of empiricism is not troubling. A free and independent people acting as they wish with their own resources is certainly no cause for concern. But there is context. Historically, America has always been a believer in the power of individual effort. Alexis de Tocqueville remarked on that penchant repeatedly nearly 170 years ago. America is a nation of doers, of believers, of joiners in common private effort for the common good. Over the last decade or so, the nation has turned ever more toward harnessing the power of philanthropy to resolve long-standing societal and economic problems, from healthcare to education to poverty. The coming global and security demands on public budgets will likely reinforce the need to turn to private solutions.

> "[Americans] have all a lively faith in the perfectability of man, they judge that the diffusion of knowledge must necessarily be advantageous, and the consequences of ignorance fatal; they all consider society as a body in a state of improvement, humanity as a changing scene, in which nothing is, or ought to be, permanent; and they admit that what appears to them today to be good may be superseded by something better tomorrow."
>
> —Alexis de Tocqueville, 1835

If this is so, then knowing more about philanthropy, its size, directions, motivations, and—importantly—effectiveness, is critical. This is not an academic matter. Illusory knowledge will be dangerous. Confidence about the ways in which philanthropy can (and perhaps cannot) hit the targets placed before it will be essential to determining whether philanthropy is effective relative to national priorities.

There are difficult questions that must be asked. They must be asked with rigor. The answers must be faced without qualm. If there is improvement needed, then it must be demanded. The nation's philanthropic institutions, and the nonprofits they fund, from the largest to the very smallest, can no longer consider themselves part of a cottage industry, an informal network focused only on their own local activities. The game is now much bigger than that. Reliable data and empirical analysis will be critical to decision making about the allocation of limited public and private resources to limitless needs.

The essays in this section address a variety of issues and questions about the linkage between future directions of philanthropy and the nation's nonprofit infrastructure and larger economic trends.

Measuring the Economic Importance of Nonprofits: What Happens When Methods Change

Given the diversity of categories comprising the nonprofit sector, it has been difficult to reliably assess the importance of nonprofits to the U.S. economy In April 2003, the Bureau of Economic Analysis of the U.S. Department of Commerce published a paper ("Income and Outlays of Households and of Nonprofit Institutions Serving Households") that set out a new analytic framework for this assessment. The results of the preliminary analysis are striking, and may become more so as the methods are used in the future.

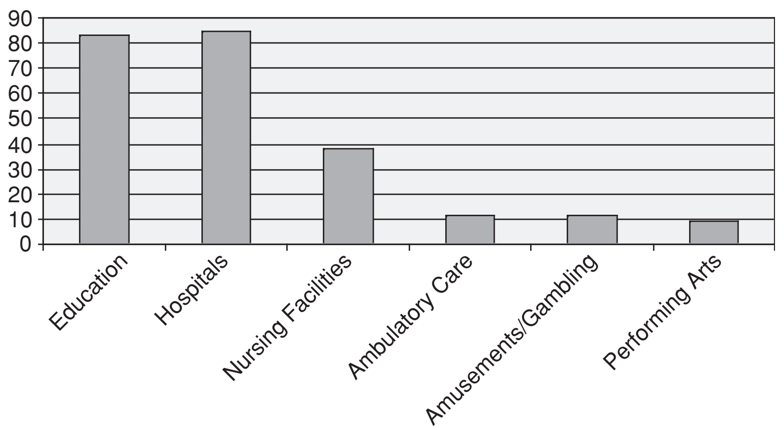
In essence, the paper argues that nonprofits engage in two broad types of transactions: those that intersect with households (e.g., museums) and those that intersect with business (e.g., chambers of commerce). Any given nonprofit may engage in both types of transactions (e.g., the museum that sells holiday gifts for business giving), but, generally, nonprofits can be categorized in these two ways. Educational institutions, hospitals, welfare organizations, and the like provide service value to households. In turn, they receive portions of the personal and household incomes of the nation, not only via charitable contributions, but also via the payment for services.

The paper then proceeds to combine what it terms "nonprofit institutions serving households" (NPISH) with personal income data to form a total picture of household income behavior. Several remarkable results ensue.

First, the nonprofit sector is nearly coterminous with four industrial sectors when viewed through the lens of the North American Industrial Classification System. NPISHs produce 83.1 percent of the private industry output of educational services in the nation, 85 percent of the hospital output, and 89 percent of the private industrial output of institutions such as museums. No surprise there. However, although discussions of nonprofits in the economy usually remark on the concentration of nonprofit output in healthcare, only 11.1 percent of the ambulatory healthcare services, and only 38 percent of nursing and residential care services output, comes from household-directed nonprofits. So it would appear that casting broad nets (such as healthcare) into the nonprofit data waters may produce a misleading catch.

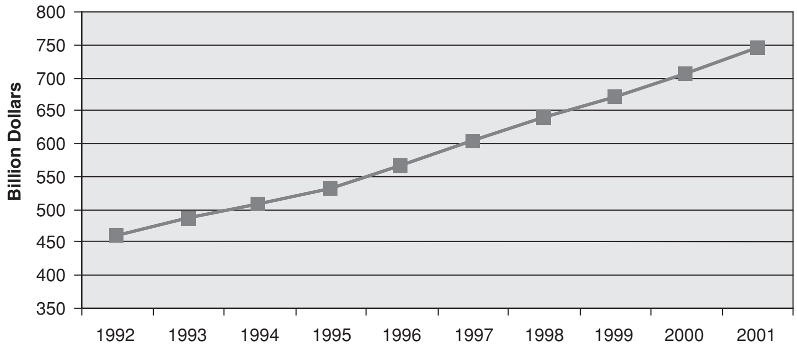
Second, viewing nonprofits as part of the household economy also results in a role for the nonprofit sector that is larger than previously estimated. Nonprofit current receipts, including transfer

EXHIBIT 1.1 PERCENT PRIVATE INDUSTRY OUTPUT FROM NONPROFITS, 1997



Source: BEA/USDOC (Mead)

EXHIBIT 1.2 NONPROFIT CURRENT RECEIPTS



Source: BEA/USDOC (Mead)

payments to nonprofit institutions from business, government, and households, totaled $743 billion in 2001, approximately a 60 percent increase in the 1990s. Based on operating expenses, household service nonprofits alone represent nearly 10 percent of personal consumption expenditures.

Third, the savings behavior of nonprofits is also important to the economy. Between 1992 and 1998, households accounted for the decline in personal savings. Thereafter, however, the gap between nonprofit expenses and sales grew to nearly $170 billion and began to play an important role in overall national savings declines.

These very different methods for looking at the nonprofit sector may become standard procedure at the Department of Commerce. If they do, they will cast a clearer light on the role of nonprofits in the economy and make distinctions among nonprofit types that have long been needed. Like all novelties, of course, they will muck up historical comparisons. So, analysts beware.

SOURCE

Mead, C.I., C.P. McCully, and M.C. Reinsdorf. "Income and Outlays of Households and of Nonprofit Institutions Serving Households," Survey of Current Business, April 2003.

Size Counts in the Foundation World: The Dilemma of Absorptive Capacity

In this bold new world where electrons are both process and content, organizations are increasingly small and/or decentralized. Innovation comes from lean, flexible organizations, centered around clients with instant communications to respond to changing needs and changing product and service opportunities. Decentralization of knowledge and action is the key to success. Indeed, three-quarters of American firms have no employee payroll at all! They are self-employed persons operating unincorporated businesses.

Speed and decentralization are everywhere. E-commerce now affects 30 percent of the entire U.S. economy. Over half of all American households are connected to the World Wide Web. Three-quarters of all Web content originates in the United States. Less than a third of working Americans are employed in companies with more than 5,000 employees. Indeed, three-quarters of all U.S. firms with payroll have fewer than 20 employees.

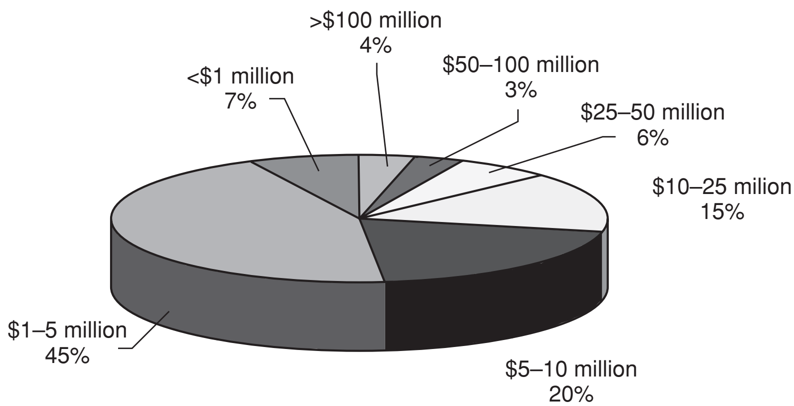
Viewed in terms of proliferation, the foundation world seems to mirror these trends of diversity. There are well over 40,000 foundations in the United States, more than half of which have been formed since 1980. This might imply a yeasty mix, generating organizational change with close and diverse community links, but the totals mask the extraordinary concentration of resources in the foundation world.

Independent foundations with assets over $100 million represent only 3.5 percent of all U.S. foundations, but they account for 67 percent of assets and 56 percent of total giving. Those with assets of $5 million or less represent over half of all independent foundations, but account for only 4.7 percent of assets and only 3.4 percent of total giving.

The picture is much more balanced on the corporate side of the foundation street. Although there are 13 behemoths of over $100 million in assets, these represent only 1.4 percent of total corporate foundations and only 9 percent of total corporate foundation giving. In contrast, those with assets of $5 million or less represent 60 percent of corporate foundations and 32 percent of giving. This is perhaps not surprising in that, as noted previously, most U.S. business is no longer "big business" in the traditional sense.

It is striking that the portrait of concentration depicted by independent foundations is replicated in community foundations. Community foundations are created to pool the philanthropy of individuals in a community so as to grow total resources and relieve

EXHIBIT 1.3 PERCENT FOUNDATIONS BY ASSET SIZE, 1999



Source: Foundation Directory

the overhead of operating very small philanthropic foundations. They represent one of the fastest-growing types of foundations both in the United States, and in Europe. In the United States, the $100-million-plus asset foundations represent 13.4 percent of all community foundations but 69 percent of giving, while those with $5 million or less are 22 percent of the total and account for only 1.6 percent of giving.

While there is increasing diversity in the foundation world, only a few of the new entrants play in the philanthropic major leagues. Does that matter?

In a way, it doesn't. The philanthropic dollars supporting nonprofit efforts are all the same color of green, whether they come from tycoons or the retired couple down the block. It would be a short list indeed of groups that refuse grants on the basis of the size of the philanthropist.

In another way, however, perhaps it does matter. The best, most successful innovation at the community level comes from contact with the community, whether that community is a church, a neighborhood, a hospital, or a school. It is possible that there is a sizing problem with foundation resources in this sense. The biggest institutions with the greatest resources must spend equally large sums to comply with tax law. Efficiency calls for moving such sums in large financial pieces, and that, in turn, results in programs that address major problems at relatively high levels of generality.

Community innovation, however, rarely comes in big chunks of high generality. Community innovation comes block by block, child by child. It may have neither the size nor the visibility to attract the attention or interest of large organizations. Even where it does, community-level innovators may not have the professional systems or organizational infrastructure to satisfy the efficiency and accountability structures that large organizations do (and must) put in place to police the efficiency and effectiveness of their resource flows.

So, when the structure of size does not match the structure of problems, opportunities for small-scale innovation at the community level may go begging. Can that be prevented? Are there ways for the 50 percent to 60 percent of giving from 3 percent of foundations to better flow to small units of community innovation? And can that be done in ways that maintain the level of intellectual rigor, promise of replicability, and strict accountability that is the burden that accompanies the privilege of husbanding huge pools of resources?

Certainly there are. This is a problem that is common in the international development community. When the World Bank or the U.S. Agency for International Development has tens of millions of dollars to allocate to a problem (e.g., gender equity) that is ill suited to absorb such levels of funding, they create community pools of funds. These pools then are supervised at the community level, and granted on in smaller amounts for appropriate activities (e.g., small business development). The World Bank cannot lend at the $5,000 level; women in Costa Rica cannot absorb at the $50-million level. Hence, the marriage between the two is made through disaggregating the total funding into smaller community pieces, giving communities input into the on-lending (or on-granting) of that amount. Large amounts of money, then, can be moved in appropriately small pieces.

The size mismatch problem between huge philanthropies and local community needs can be resolved. But doing so will require creativity in project design, on the part of the funders, and organizational entrepreneurship, on the part of the communities.

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What You Know or Who You Know? Relationships Matter

There is often great debate over whether what you know matters more than who you know. But, whatever the universal answer, in the world of philanthropy who you know matters a lot.

Some 70 percent of all giving in the nation is from individuals. So networks are a critical part of success for those organizations seeking charitable support. Reaching out to individuals is the key to philanthropic success.

What is not generally recognized is how important "who you know" can be in the world of organized philanthropy, specifically in the world of foundations. There are more than 40,000 registered foundations in the United States. But the sum does not reflect the nature of its parts. The foundation world is highly segmented, with the vast majority of foundations serving only organizations in specific geographic regions or localities. This is well-recognized.

That said, the foundation world can also be impenetrable to nonprofits even within geographic confines. On average, 17 percent of foundations preselect their grant recipients.[1] That is, they do not accept unsolicited proposals, even within the geographic or substantive areas of their concern. So who you know can be

[1]Percentages in this essay are derived from the foundation sample contained in the Taft Group's Prospector's Choice. The sample includes both private and corporate foundations. Regional subgroupings and associated data were developed by the author.

EXHIBIT 1.4 PERCENTAGE OF FOUNDATIONS PRESELECTING GRANTEES

Region	Percentage
New England	17%
Mid-Atlantic	23%
Southeast	11%
South	14%
Midwest	16%
Plains States	9%
Mountain States	12%
West/Southwest	20%

quite important indeed. In fact, the actual percentage is probably much higher. The sample used includes corporate foundations, most of which allow, and even encourage, applications from a wide range of groups in the communities they serve. Netting out corporate philanthropy would reduce the denominator to private independent foundations but not decrease the preselect numerator, hence the preselect numerator, hence the preselect rate would rise.

The national pattern differs by geographic region. Only 9 percent of foundations in the Plains States preselect recipients, while the Mid-Atlantic States lead the nation with 23 percent preselecting. The prize for exclusivity goes to New York State, where nearly a third (32 percent) of all foundations do not accept unsolicited proposals. Rhode Island comes in second, with a 29 percent preselection rate, followed by California at 25 percent.

Furthermore, preselection is more characteristic of cities than of nonurban philanthropy. A full 36 percent of New York City's foundations do not accept unsolicited proposals, followed by Los Angeles at 26 percent and San Francisco at 25 percent. In terms of the difference between statewide and city preselection rates, however, the prize goes to Seattle, where 22 percent of foundations preselect compared to 11 percent elsewhere in Washington state, with second place to Boston, where 24 percent preselect, compared to 15 percent elsewhere in Massachusetts.

So, nonprofits would be well served to take a page from the real estate industry. In real estate, what matters is location, location, location. In philanthropy, it appears that what matters is networking, networking, networking. Or, to the reader interested less in commerce than in philanthropy and the arts, heed the pen of William Shakespeare: "Those friends thou hast, and their adoption tried, grapple them to thy soul with hoops of steel." (*Hamlet*, I, iii, 61)

Foundation Endowments: How Big, How Vulnerable?

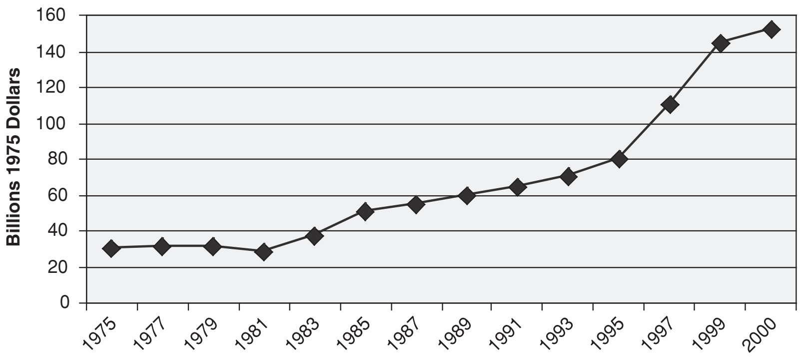
With the ups and downs of the stock market, much has been written about fluctuations in the size of foundation endowments and their (theoretical) moral might in the marketplace. As in many other areas, the conclusions to be drawn depend on where you begin.

The Foundation Center estimates a total U.S. philanthropic endowment base of something on the order of $480 billion in current dollars in 2000 (about $152 billion in inflation-adjusted 1975 dollars). This represents a fivefold increase since 1975 in real terms. After lackluster performance into the mid-1980s, assets experienced double-digit real growth in the 1995–1999 period. Of this total, about 6.7 percent ($30 billion) is held by community foundations and 3.3 percent ($15 billion) underpins corporate foundations. The remaining 90 percent represents the capital assets of private, independent foundations.

This is almost certainly an underestimate. By the center's own admission, it does not include many small foundations. But four other categories are also missing, or at least undercounted.

First, the estimate does not (and perhaps cannot) keep pace with market changes in the private sector. For example, the merger of the nonprofit USA Group with Sallie Mae in 2000 immediately kicked $700 million into the USA Group Foundation. The endowment of the Annie E. Casey Foundation (created by UPS) nearly

EXHIBIT 1.5 INFLATION-ADJUSTED FOUNDATION ASSET GROWTH, 1975–2000



Source: Foundation Yearbook, 2002

doubled overnight (from $1.7 billion to $3.3 billion) when UPS went public. But being beholden to a single stock also has its disadvantages. When Hewlett-Packard stock lost 50 percent of its value between July and October 2001, the fortunes of the Hewlett-Packard Foundation, whose assets were tied to stock, plummeted as well. A snapshot at any point in time will miss the fluidity of values over time, hence may risk misrepresenting the state of overall foundation capacity.

Second, the estimate probably does not include most association foundations—that is, independent foundations created by professional, avocation, or industry associations. There is no comprehensive census of these foundations; but a rough assessment based on association directories indicates that as many as 700 associations have created affiliated foundations. Some are exceedingly small (e.g., the Pot Bellied Pig Association Foundation), but some are significant (e.g., those affiliated with major medical specialties or national voluntary health associations). In aggregate, such foundations probably raise hundreds of millions of dollars annually, and support not insignificant amounts of research and public education.

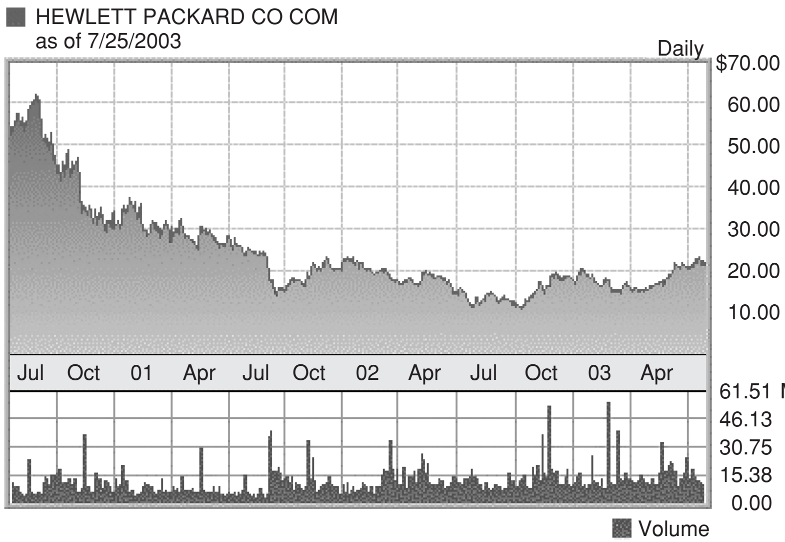
Third, the estimate does not include all foundations that house and manage university endowments. Nearly a third of all giving to universities goes for endowments. As an example, the University of Florida Foundation alone holds nearly a billion dollars in assets.

Finally, the estimate does not include the controversial new entrants into philanthropy—the donor-advised funds of Wall Street's money management firms. The philanthropy windows of Fidelity, Schwab, and Vanguard alone have total assets of over $2.4 billion, and Merrill Lynch has now set its sights on knocking Fidelity from the top of the donor-advised fund heap.

So let's assume that $360 billion is an underestimate. Let's further speculate that it is off significantly, say by 50 percent. How big is the resultant half a trillion dollars of capital?

In fact, it is not so big. U.S. nonprofits control about $1.9 trillion in assets (although admittedly this includes state pension funds, but no longer includes TIAA/CREF, which has been stripped of its nonprofit status). Thus, foundations would represent less than a third of this total. But beyond the nonprofit world, the U.S. financial markets include $16 trillion in professionally managed

EXHIBIT 1.6 HEWLETT-PACKARD STOCK PERFORMANCE, JULY 2001–APRIL 2003



capital. At even $500 billion, foundation endowments would be only about 3 percent of that total!

While it is true that $500 billion is hardly loose change out of the top drawer, why is it not more? Why are there not more endowed foundations, and why are those endowments not larger? The answer is certainly not that foundations are giving away their asset base. Most do not exceed the IRS requirement that they give away 5 percent of their base. With market gains in the double digits, assets have been growing, even when recent downturns are factored in. It is also almost certainly not that foundations are settling for smaller investment returns because they choose to trap their assets in socially responsible investment funds. Most foundations do not use social issues as investment criteria.

Moreover, socially responsible investment funds are now often outperforming the overall market. Hence, for those foundations that do tear down the wall between the social issues that drive their grants and return on endowment capital, investment yields continue to be impressive.

So, is the issue not the growth of endowments that exist but the growth in the number of endowments? There may be at least three factors at work.

First, decision making about resources. A foundation with an independent board may not behave in accordance with the wishes of the founding organization. Many of the classic examples come from the academic world. The nearly decade-long feud between the University of South Alabama and the University of South Alabama Foundation is a case in point. Philanthropic structures that retain assets within the recipient organization without benefit of a parallel foundation may be seen as simpler means for ensuring management control.

Second, the complexity of establishing and managing a foundation is not trivial. The rule of thumb is that $1 million is the minimal "opening bid" for establishing an independent foundation. Many individuals and families have the option of annual giving or giving via the new donor-advised funds just noted. In fact, in inflation-adjusted dollars, new capital received usually represents less than 5 percent of total foundation assets. Even in the go-go 1990s, record levels of new gifts still only accounted for, at most, 9 percent of foundation asset growth. And even these record gift years were skewed by the multibillion dollar endowment of the Gates Foundation. Clearly, establishing a foundation or growing an existing foundation is not the engine behind philanthropic growth.

Third, most people committed to giving are also committed to impact. There may be a tendency to see endowments as less productive relative to impact than direct and immediate giving to the nonprofit in need. The foundation model might be seen as an unnecessary "middleman" in a giving strategy.

Fourth, new, big pools of money are not immediately attracted to the foundation model. Conversion of community health institutions to for-profit status over the last 15 years has resulted in over $14 billion in community charitable foundation endowments. There is a growing concern in the newest category of private sector conversions, community banks, that this approach has more risk than reward. Some banks have used part of their new stock to endow associated foundations; some have not. A 1999 analysis of the annualized return on capital of thrift institutions would seem to support that caution. The study compared community thrifts that created foundations with stock donations upon privatization with those that did not. Of the 55 community thrifts that went public between January 1998 and December 1999, those with new foundations (30) had an annualized return of 2.73 percent. Those without foundations enjoyed a return of 8.86 percent, 225 percent higher. For these conversions, the newest question is how to respond to their community roots without compromising working capital.

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Does Philanthropy Interfere with Markets?

In the next several decades, as much as $38 trillion will change hands from members of the boomer generation to their progeny and, to some extent, America's charities.[1] And the ranks of those charities have grown enormously. In 1940, the nation had 15,000 nonprofits; today there are an estimated 1.6 million, of which about 700,000 are providers of services to households.

> "To give away money is an easy matter and in any man's power. But to decide to whom to give it, and how large and when, and for what purpose and how, is neither in every man's power nor an easy matter."
>
> —Aristotle

By any measure, these are not trival numbers. Beyond their eye-popping magnitude, however, such numbers raise a variety of interesting questions about how these expanded resources and growing institutions will map onto the larger economy. Let's begin with a basic economic parameter: Will the new money value efficiency?

[1]The exact amount of the transfer is, of course, dependent on assumptions about markets. As of January 2003, the range of $38–$41 trillion was still considered valid, despite the three-year economic downturn.

In an open marketplace, resources flow to efficient organizations. Assuming that product or service demand can be expressed in the market (efficiency was of little importance in Soviet systems, for example), efficiency drives down costs and boosts productivity, attracting both demand and investment and spurring competition. That is the beauty of markets.

Does efficiency matter to philanthropy? Perhaps more troubling, does philanthropy actually impede efficiency? As to the first question, the answer would appear to be no, or at least, not much. Research from 2001 by P. Frumkin and M.T. Kim examined philanthropic flows to a sample of nonprofits over 11 years. Efficient organizations (defined in terms of administrative costs) fared no better than inefficient ones in attracting individual, corporate, or foundation philanthropic resources.

These are sobering findings. They imply that the philanthropic dollar (or 38 trillion philanthropic dollars) does not reward efficiency and, where it attempts to do so, faces difficulty instigating or improving efficiency measurably. The further implication is that society (which is voluntarily forgoing tax income on those dollars) accepts (or will need to accept) the degree of waste that accompanies inefficiency.

The second question—does philanthropy impede markets—rests equally uneasily on the shoulders of the future. Of course, for many philanthropic targets, markets are not an issue. There is no market for soup kitchens or for homeless shelters, for example. But for others, markets do operate, and they operate with increasing public acceptance. Healthcare is a prime (but far from the sole) example. A hypothetical example will illustrate the difficulties inherent in the tension between philanthropy and the market.

Assume there are two teaching hospitals within a one-mile radius in a city that all analysts acknowledge has too many hospital beds relative to efficient medical management and cost structures. They both are affiliated with large medical schools, have comparable world-class research, and regularly vie for "best hospital" in national rankings. Neither, however, can fill more than 60 percent of its beds; each has at least one empty floor.

Though access to primary and preventive care may be problematic in the city, there is no evidence of unmet demand for the type of tertiary care provided by teaching hospitals. Given their cost structures and reimbursement rates, negotiated in competition with other hospitals in the city, both hospitals have run operating deficits for the past three years. Both have powerful boards and are initiating multiyear fundraising campaigns to cover deficits and build yet more buildings. Egos are at stake, and the philanthropic betting says that both will achieve their fundraising goals.

The product is the same. The quality is the same. The proximity to market is the same. Underutilization is similar. Financial vulnerability is shared. Nevertheless, philanthropy allows both to exist; left to its own devices, the market would drive toward efficiency either by scaling both back, shutting one completely, or merging both. Two added difficulties compound the problem.

First, the healthcare industry is not the cement industry. Life and death are matters of deep importance to most individuals. Institutions that hold life and death in their hands are, therefore, intimately bound up in community expectations that extend beyond market performance.

Second, nonphilanthropic healthcare dollars are dear. Scarce resources (public and private) must regularly be spread across competing life-and-death needs. These decisions affect patients and the communities these healthcare institutions serve. So, by enabling the continued existence of inefficient providers, does not philanthropy's role raise questions of distributive justice for the allocation of scarce funds (public, payor, and consumer) that have both a market and a societal purpose?

Of course, health is not a perfect market. Clearly there are values on the public commons that justify less-than-perfect efficiency in the location, size, and operation of healthcare facilities. But the hypothetical illustration just presented is not very far removed from the overbedding reality in many urban areas of the nation. In large cities, hospital service duplication and overbedding, hence inefficiency and cost escalation, can be maintained in part because of community demands and in part because philanthropic financial leadership allows institutions to escape the effects of supply and demand.

The healthcare market does, in fact, operate in the United States. Whether or not it has produced better medicine is a matter of debate. But it has certainly increased the efficiency with which healthcare resources have been applied to provision.

Is philanthropy fuel for using every scarce dollar wisely? Or is it a brake on efficiency? The influx of trillions of philanthropic dollars into systems that operate with scarce resources in market conditions suggests that the question is not academic. If a significant presence of philanthropy in an economic sector impedes the continued achievement of efficiency and productivity in that sector, then the overall economic commons may, in fact, suffer rather than benefit.

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Venture Philanthropy: Two Sides of the Coin

AN IDEA WHOSE TIME HAS COME

Charitable giving—of time and money—is an acknowledged pillar of American culture. A recent study by Johns Hopkins University estimated that 49 percent of Americans volunteer their time for civic activities, compared to 13 percent of Germans and 19 percent of French. Similarly, nearly three-quarters of Americans make financial contributions to charity, compared to 44 percent of Germans and 43 percent of French. Indeed, U.S. charitable giving garners nearly a third of a trillion dollars per year, about one-third the total of the entire U.S. government domestic budget.

But, as with any large and complex endeavor, major change does not come easily. The Queen Mary does not turn on a dime. Neither does America's approach to philanthropy.

The philanthropic "buzz" over the last several years has been the rise of *venture philanthropy*, an approach that takes the principles of entrepreneurial business financing and applies them to charitable giving. Yet only an estimated 5 percent of giving falls in this category. What is venture philanthropy and is it so different?

In effect, venture philanthropy attempts to break what, in other work, I have called the greatest tragedy of post-World War II society—the donor-recipient relationship. By conceiving of and treating individuals (or organizations or even entire nations) as "recipients," we should not be surprised that this is how they begin to think of themselves. Hence, creating self-reliance is predictably difficult. The recipient receives from the donor. Therein lies the tragedy. The very approach creates dependency. Venture philanthropy is different from traditional philanthropy in at least four ways.

> "The dignity of the individual demands that he not be reduced to vassalage by the largess of others."
>
> —Antoine Saint-Exupery

First, it supports a relationship between investor and "investee." Far from that between a donor who gives and a recipient who receives, this relationship is more akin to a partnership, in which all parties have a mutual interest in success. The relationship is built on equality, not on dependency.

Second, the partnership is not merely about money; the investor also proffers human assets—professional time and skills—and, often, scarce goods (technology) to ensure that the investee is building the organizational capacity to pursue the investment over the long term. Venture philanthropy is not a matter of writing checks for good works; it is a personal and organizational commitment between partners.

Third, accountability for performance is the "bottom line." The venture philanthropist, and by definition the organization in which he/she is investing, is interested not in charity but in solutions. Systems for aggregating evidence of performance against which the investment will be held accountable are critical.

Finally, it drives toward sustainability. Just as no entrepreneur works 70 hours each week in order to create something that cannot last, so the venture philanthropist seeks sustainable initiatives, seeks to support programs and organizations that demonstrate their own commitment to survival without philanthropy. The venture philanthropist, in effect, seeks to invest such that, ultimately, philanthropy goes out of business.

This venture philanthropy movement has most widely been identified with the new wealth generated by the electronics and telecommunications economy. This remains the core. But, here and there, the nondot-com philanthropic world has begun to change as well.

A (perhaps startling) case in point is the Innovation Fund created by the Franciscan Sisters of the Poor Foundation.[1] With the divestment of their healthcare facilities, the Sisters and the foundation reexamined the directions of their philanthropy within the Sisters' core religious and social mission to serve the poor. The Innovation Fund is an effort to support a variety of social service sectors, but with a rigorous demand that the initiatives be clearly innovative relative to other approaches, quantitatively demonstrate impact, and build sustainability into the initiative from its very inception. Proposals are considered only after an initial brief letter has been submitted to document both the need and the innovation of the approach. The Grants Committee of the foundation board is intimately involved in monitoring development of a full proposal and in subsequent site evaluations. Finally, although innovative approaches to complex problems take time, the foundation's multiple-year commitment to any organization will be withdrawn if services do not begin to flow to the needy population within one year of start-up. Theory must become reality, not a dissertation.

This is but one example. There are others in the nondot-com world. Too few, perhaps, but the recognition of the need for innovation, accountability, and sustainability is growing. But how different is this, really? Certainly, venture philanthropy differs from many approaches to "charity" of the last several decades. It has broken forcefully with the tendency of philanthropy to ask few questions and demand few answers. Yet it is not so different from the early approaches to philanthropy of major American foundations. Andrew Carnegie's effort to build lasting libraries in every community strove for sustainability and impact at the fundamental level of community learning. The early Rockefeller Foundation's

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[1]The author served as a member of the board of the foundation and as chair of the Grants Committee, as well as having designed the Innovation Fund.

push to eradicate yellow fever, and the subsequent support of major U.S. philanthropies in the global campaign to eradicate smallpox, all were clear examples of early approaches that carefully selected problems, targeted the best minds and best technologies at them, and then drove toward a full and complete solution.

So, in a way, venture philanthropy is not so much a new phenomenon as a return to the roots of U.S. philanthropy. It may become a reaffirmation that investing in terrific ideas carried out by powerfully capable people and organizations targeting critical societal needs can bear lasting, meaningful results.

> "As I study wealthy men I can see but one way in which they can secure a real equivalent for money spent, and that is to cultivate a taste for giving where the money can produce an effect which will be a lasting gratification."
>
> —John D. Rockefeller

. . . OR JUST A BAD IDEA?

In sum, venture philanthropy seeks to hold social action and nonprofits to the same standards of performance that the new philanthropists themselves had to meet to attract market venture capital and build the new burgeoning economy.

The central problem, of course, is that the societal problems addressed by much of the nation's nonprofit infrastructure differ elementally from market opportunities. For some problems, root causes are not even clear, hence strategic action with measurable results is difficult to design. If you do not know, fundamentally, why Johnny cannot read or why Jane hates or why Joe chooses the street over a safe shelter or why Jean knowingly risks disease and death, then we will have difficulty crafting an effective intervention. Core societal flaws—fault lines created by human weakness, historical events, cultural mandates, and the like—give rise to significant dilemmas in any nation. The foundation for responding to such problems consists of 10 percent knowledge and 90 percent risk—and even the 10 percent is often imperfect.

For such problems, investments that demand strategic interventions and measurable results over the short term (for example, perhaps, in less than a generation) may demand too much. The risk factor is simply too high. For philanthropy, the question is clear: Is there not a floor to problem selection? Is there not a set of problems that are so complex, so poorly understood, so fundamentally entwined in societal structure that, at least for now, they call for a purely charitable approach? Is not charity—pure-and-simple giving because shared human destiny and common human respect demand a moral response—a socially appropriate and intellectually defensible response?

> "In charity there is no excess."
>
> —Sir Francis Bacon

But even short of these fundamental, generational problems, venture philanthropy, in turn, poses a series of questions for the nonprofit community. These questions are not imponderables, but they will require the expenditure of considerable energy from between the ears of nonprofit leaders.

How do we measure results in ways acceptable to philanthropists who are used to starkly clear market indicators like price per share? What should be measured? Outcome (clients served, food distributed, classes given) or impact (change of behavior)? And if it is impact that investors seek (a fairly sure bet, it would appear), then how can program intervention into complex problems with multiple causes be shown to have sufficient social return? And what is "sufficient?"

Is a venture philanthropy approach scalable? Perhaps, with insight, hard work, and even a bit of luck, programmatic intervention in a neighborhood can be demonstrated to have investment return on social measures. Perhaps it will even be sustainable in the community. But such initiatives will need to build in significant efforts in communication across the nation to achieve broader results. Nonprofits will need to explore whether a successful venture philanthropy approach to a problem on a limited scale can be applied more broadly (to a larger place, or more complex population).

What is the time frame? Over what period does the investor expect results? And is that time period reasonable from the viewpoint of the nonprofit and from the viewpoint of the investor? Let us be frank: There is a tension here. To the extent that venture philanthropy is impact-oriented, to the extent that it seeks sustainable solutions in reasonable time frames, it may work to the organizational disadvantage of the nonprofit. Under these conditions, philanthropy ceases to be a reliable income flow to nonprofits to meet general operating costs of their core organizations over time. Instead, when philanthropy seeks impacts and solutions for investments made at a particular point in time, it clearly implies that the philanthropist assumes an exit strategy. In that context, no time frame for impact may be organizationally comfortable for the nonprofit, because success means the investor exits. Hence, the nonprofit and the philanthropist have quite different assumptions about the task at hand. One wants a specific return on investment in a clear time frame, the other wants operating support indefinitely.

Finally, is the nonprofit sector up to the task? Are most (or even many) nonprofits staffed to develop the types of specific, efficient, goal-disciplined, output-oriented, measurement-intense organizations implied by a venture philanthropy approach? Do nonprofits—community groups, social service agencies, religious communities, welfare advocates—have the horses on the track to run this race? Currently, probably not. A change in philanthropic approach, if it spreads widely, will require aggressive and rigorous leadership in the nonprofit community to ensure that organizational capacity adjusts.

In the past decade, there has been a 40 percent increase in the number of nonprofits in the United States. In the end, it is leadership that will matter. Nonprofits will need to meet venture philanthropy on its own terms, with the skills, responsiveness, and creativity that a new generation of philanthropists are used to seeing in the marketplace. As in any market, the money will follow the combination of great ideas and creative management. And, as in any market, organizations without great ideas and creative management will find their future in doubt.

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Wages in the Nonprofit Sector: Poor Cousin or Twin Sister?

Conventional wisdom holds that compensation in the nonprofit world is a poor cousin to pay scales in the for-profit world. If you want to "follow the money," the street signs all point to corporate America. Moreover, if that is so, wisdom continues, overtures by nonprofits to the workforce are most likely to be successful when pitching cause rather than cash.

But, as with all conventional wisdom, the truth appears to be more complex. In 1999, top executives in nonprofits received median pay increases of 6.2 percent, more than the 4.2 percent recorded in the private, for-profit sector. The median compensation for surveyed CEOs was $225,924, perhaps not equivalent to the corporate stratosphere, but certainly better than, for example, a U.S. Cabinet secretary's annual take of $150,000. The highest-paid nonprofit CEOs are to be found in the health sector, where CEO pay can exceed $450,000 per year.

The more interesting question is how compensation compares for the larger workforce. The story here appears to have at least three layers.

For some categories of nonprofit industries (e.g., healthcare and nursing facilities), pay levels are comparable to those in the for-profit sector. Certainly, part of this trend is due to the effects of organized labor in some sectors. In part, it is also a function of the ways in which services are compensated. Insurers pay for health services on fairly fixed schedules, irrespective of the market status of the provider. Hence, the drive toward cost containment is equal for the for-profit and the nonprofit healthcare provider.

For highly trained personnel (information systems managers, lawyers, financial managers), the for-profit marketplace probably does offer higher compensation. Hence, finding the trained personnel to bring nonprofits (especially small ones) into the age of electronic communication and the Internet does represent a challenge for nonprofits. This is particularly true because, irrespective of cash compensation, the siren song of stock options has (until the NASDAQ's implosion) been clear and sweet.

For the majority of workers, however, the compensation gap between for-profit and nonprofit is much smaller than expected. The National Bureau of Economic Research (NBER) found that, over time, workers who move from the for-profit to the nonprofit sector only experience a wage penalty of between 2 and 4 percent. Indeed, looking at the New York area, comparison of overall compensation levels for such positions as public relations, sales management, and clerical positions indicates little difference between nonprofit pay levels and the region's average.

There is one outstanding question, however: What happens as people get older? How do the compensation levels for young workers in the for-profit and nonprofit sector compare to similar levels for those who have been on the job for several decades? This is a critical question, because it might reveal the potential vulnerability of professional experience in nonprofits. The lesson from the teaching profession provides a sobering warning.

The wage gap between teachers and all other workers with a similar education varies tremendously across the nation, from a high of 60 percent in places like Texas to 18 percent in places like Connecticut. As a national average and taken as a whole, teachers experience only a $7,000 difference in compensation relative to equivalent workers from other economic sectors. However, by age 45, teacher compensation is on average $24,000 less per year. Over time, workers in other sectors and professions grow their compensation packages much more rapidly than do teachers. The result: an experience drain out of the teaching profession.

An interesting (and important) research question would be whether the same phenomenon happens in the nonprofit workforce. Does the NBER's 2 to 4 percent penalty grow greater as workers age? If so, is it possible that the experience drain that plagues education will come to bay at the heels of nonprofits as the American population ages?

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Diversity and Governance: The Not-Good News

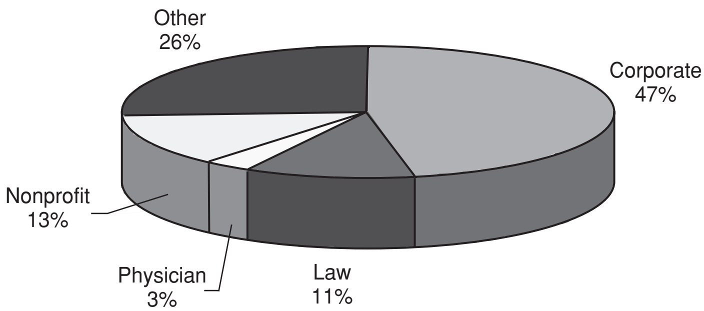
The issues of diversity and inclusion in governance—whether for nation states or private organizations—justifiably belong on the top ten list of concerns of private and public organizations everywhere.

Philanthropy is no exception. Grantmakers seek to affect societal dilemmas. Arguably, they would make the most insightful decisions about how to do that if their decision-making structures (as represented by their governing bodies) reflected a broad swath of society. So, to paraphrase the Big Apple's former mayor, Ed Koch, "How're we doin'?"

If the limited data available are any indication, the answer would seem to be, not too well.

Using the Taft Corporation's index, Prospector's Choice, a random sample of 142 private, independent foundations in 47 states was selected. The sample did not include Montana, Maine, or Idaho because board of directors data for foundations in those states did not include sufficient information to characterize the backgrounds of board members. The total board member sample for these foundations was 846 individuals. Board size ranged from a high of 19 to a low of 2. Within this sample, the backgrounds of about 75 percent of the board members could be determined. Of course, racial or ethnic makeup was not traceable. Still, there was a surprising homogeneity to the sample. Nearly three-quarters of board members (72 percent) were male. Nearly half (47 percent)

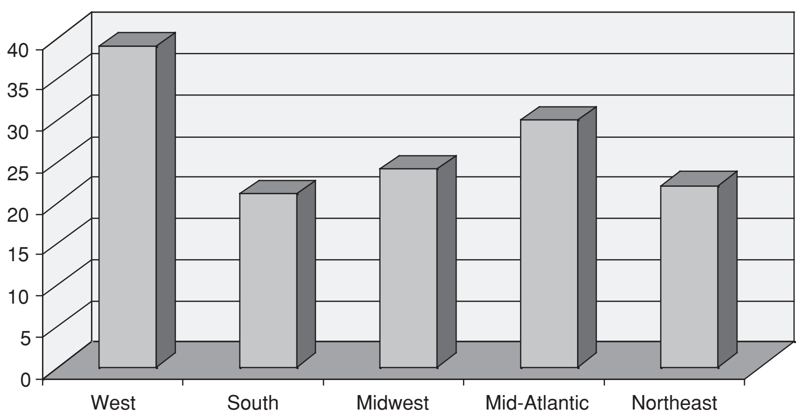
EXHIBIT 1.7 FOUNDATION BOARD COMPOSITION BY PROFESSION



Source: Changing Our World Sample

had current primary employment in the corporate world. Another 11 percent were practicing lawyers. In the "doctor, lawyer, merchant chief" troika, doctors were definitely also-rans. Only 3 percent of foundation board members were physicians. Another 13 percent were currently employed in the nonprofit sector, including educators and religious leadership.

EXHIBIT 1.8 FOUNDATION BOARD COMPOSITION—PERCENT FEMALE BY REGION



Source: Changing Our World Sample

Between 25 percent and 33 percent of the board members, irrespective of professional background, also held governance seats on other foundations or nonprofits. This interlocking board rate can be seen as a plus in the sense that board members are experienced in issues related to nonprofit management. But it can also be seen as a negative in the sense that it measures how narrow the absolute pool of board participants really is.

Most striking was the gender gap in philanthropic governance. Furthermore, that gap seems to narrow significantly only on the West Coast. Foundations in the Northeast, Midwest, and South trail significantly behind, and the Northeast is head-to-head with the South for dead last in board gender balance.

Obviously, these observations do not a dissertation make. The sample may be biased, although excluding Montana probably did not skew the analysis. Questions of the correlation of diversity with other factors such as foundation size are relevant. But the depth of the concentration of board leadership, measured by either gender or current employment, raises at least the suspicion that even further analysis would not significantly change the conclusion.

Does it matter? Perhaps not. There is no research that supports a reliable correlation between gender and wisdom or between profession and acumen. Smart people come to the party wearing many cloaks. Equally, there is no correlation between competence and chromosomal makeup.

Still, to the extent that, as a nation, we seek to ensure that decisions about resources targeted at societal problems reflect the perspectives of those involved, it would appear that philanthropies may have some housekeeping of their own to do.

SOURCE

Data from the Taft Corporation, Prospector's Choice.

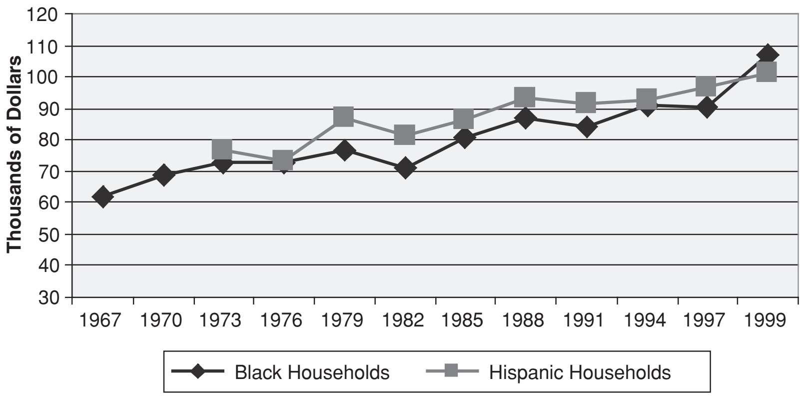
Minority Philanthropy: The Future Has Arrived

The longest period of economic growth in the nation's history has lifted many boats. And, increasingly, modern philanthropy is not just about the mega-rich. It is also about Americans from all walks of life. The number of small family and community foundations has doubled since 1980. Among the significant actors in the growth of current and future U.S. philanthropy are America's minorities. By the end of 2000, 28.7 percent of the U.S. population was nonwhite (79.13 million people) compared to 12 percent a century ago. By 2015, that portion is expected to rise to 30 percent.

Let us pause, however. It is important to acknowledge that the economic good times have not resolved the nation's poverty problem. Indeed, poverty rates for full-time workers have stayed constant in the last two decades, and wealth concentration in the uppermost tiers of income levels has increased. Moreover, the economic elevator goes both up and down. Three-quarters of Americans can expect to see their annual income rise or fall by 5 percent in any given year.

Still, it is important to recognize that economics is creating new philanthropic leadership in American minority communities. In the African American community, the philanthropic spirit is not, admittedly, a "new new thing." Charitable giving in the black community dates from at least the late 1700s, when Richard Allen and Absalom Jones founded societies of free men to support poor

EXHIBIT 1.9 LOWER-INCOME LIMIT OF TOP 5 PERCENT OF HOUSEHOLDS (1999 CONSTANT DOLLARS)



Source: U.S. Bureau of the Census

widows and orphans. Indeed, the Underground Railroad of 1804 certainly qualifies as a black philanthropic effort, with a social return on investment that would satisfy even the most hard-nosed of today's venture philanthropists! Economics is further enabling this history. In metropolitan Boston, with the fastest-growing urban black population in the nation, household incomes among blacks rose 40.2 percent in the 1990s. This change is striking in comparison to the overall Massachusetts increase of only 16 percent and the national increase of 11 percent. Nationally, 25 percent of African American households are in the top two quintiles (top 40 percent) of income. In the black community, 53 percent of households made charitable donations in 1997, up from 51 percent in 1993. This contrasts with a decline in the national average from 73 percent to 69 percent in the same period. Some 60 percent of African American giving flows through church communities.

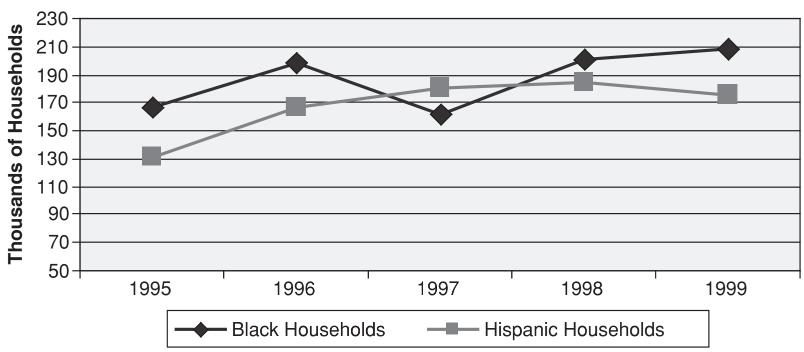
In the Hispanic community, poverty rates have dropped to their lowest levels since the late 1970s. Less than a quarter (23 percent) of Hispanic households are below the poverty level, and median income rose 6 percent between 1998 and 1999. Latino business leadership is also stepping into the front lines of philanthropy. The

New America Alliance has been formed by Latino entrepreneurs interested in addressing deep-rooted problems within their own community, as well as in creating greater opportunities for Latino entrepreneurs.

Immigrant minorities are also major philanthropic players. In recent years, the United States has received more than 1 million immigrants annually, 660,000 legally and an estimated 300,000 without documents. The United States is now home to nearly 30 million foreign-born residents. More than 25,000 high-tech émigrés from India have settled in the United States to lead the technology explosion. They now run more than 750 technology companies in Silicon Valley alone. Immigrant giving is global. Beneficiaries are not just communities in which immigrants live and succeed, but also those back home. In 2002, the United States recorded $32 billion in remittances to Latin America alone from foreign-born workers sending money to their home countries. Nearly 23 percent of all international remittances originate in the United States.

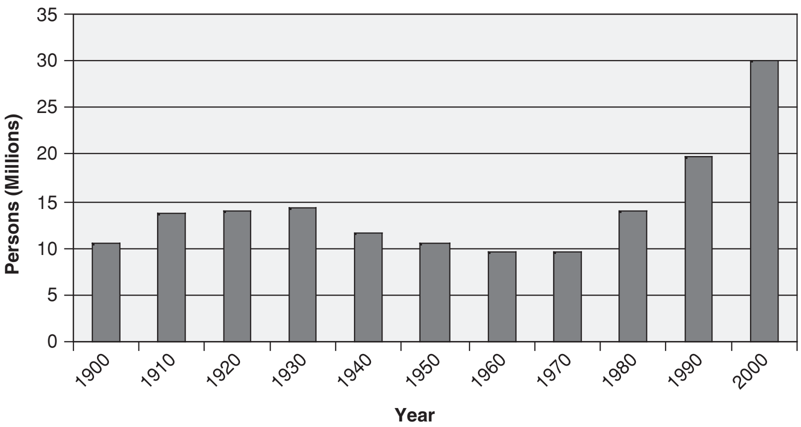
In the United States, minority leadership in philanthropy tends to focus resources on deep and historically intractable social problems, seeking to work creatively at the community level. Minority

EXHIBIT 1.10 NUMBER OF HOUSEHOLDS WITH INCOME IN TOP 5 PERCENT OF MINORITY HOUSEHOLDS RISES 25 PERCENT



Source: U.S. Bureau of the Census

EXHIBIT 1.11 FOREIGN-BORN INDIVIDUALS LIVING IN THE UNITED STATES



Source: U.S. Bureau of the Census

resources also focus on opening up market opportunities for their communities, so that progress on the educational and social fronts will lead to progress and stability economically. While the "new philanthropy" that generates eight-figure donations to academic centers may grab the headlines, it is quieter, less-flashy minority philanthropy that may be making the most creative investments in street-level solutions to the nation's enduring social and educational inequities.

The longer America can preserve and extend economic growth, the more new entrants to philanthropic leadership will come from America's minorities—and the more robust and creative will be the philanthropic landscape.

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Will There Be a Nonprofit Shakeout? Comparing Nonprofits to Small Business Trends

The vast majority of U.S. nonprofits are extremely small (with less than $25,000 in annual income), with limited capacity to support major investments in technology or management. They are close to their community need, and dominantly run by volunteers. These are organizational assets. But, they are likely not well positioned to take advantage of the $38 trillion intergenerational transfer of wealth. What will happen? Two trends provide food for thought, one from small business and one from the nonprofit sector in New York City.

Small business is similar in structure to the nonprofit sector. Fully 20 percent of America's 5.8 million small business establishments have annual revenue of less than $100,000. Nearly 50 percent have revenues of less than $250,000. Only 6 percent have sales of over $1 billion. Just as in the nonprofit sector, the base of the business pyramid is very broad; the top is very narrow.

But, in contrast to nonprofits, in the small business model, "business death" is a common, and indeed healthy, phenomenon. Annually in the United States, between 550,000 and 600,000 small businesses are born each year; only about 50,000 more than the number of small firms that die. However, the overall numbers are misleading. In 2000, in 31 of 50 states, the rate of termination of small business exceeded the rate of small business formation. In 31 states (but not necessarily the same 31), the number of terminations in 2000 exceeded those in 1999. Such turnover is an indicator of economic growth, as new firms replace outmoded ones. Even with the churn of birth and death, small business employment has risen by nearly 11 percent in the last decade, wage and salary income has risen 71 percent, and nonfarm proprietors' income has nearly doubled.

Change is indeed good. And the change is not all due to business "failure" as measured by bankruptcies. Annual small business bankruptcies have declined by nearly half in the last decade. The birth-and-death cycle is driven by closures (for whatever reason) of firms in which entrepreneurs pursue other opportunities, or by mergers. Small business mergers totaled $12 billion at the end of the 1990s. And the merger phenomenon characterizes the bottom of the pyramid as much as it does the top. In the mid-1990s, more than 1,000 mergers took place for which the transaction was worth $50 million or less.

Could the dominance of small nonprofits within an environment of huge wealth transfers lead to similar results? Might the nonprofit sector begin to see a death cycle, as new opportunities are created by growing firms at the mid- and large-sized levels, and as small nonprofit founders and managers pursue these new opportunities? Will that wealth transfer also create an urge to merge? Will small nonprofits, seeing the cycle begin, actively pursue mergers so as to better position themselves to access the wealth transfer?

If change is good for business, might it not also be good for nonprofits? There may be some evidence from the nonprofit sector itself that these patterns are on the horizon.

The May 2002 report on New York City's Nonprofit Sector, published by the Nonprofit Coordinating Committee of New York, indicated that nearly a quarter (24 percent) of surveyed nonprofits in New York City pursued joint venture or merger efforts with other nonprofit or for-profit organizations in an effort to increase revenues. The motivation for the "urge to merge" is more striking when the survey data are combined with data in a later section of the report. According to the report's scenario analysis, 29 percent of New York's public charities had deficits in 2000. If total revenues were to decline by 15 percent, that portion would rise to 71 percent. In that case, the total net income of public charities in New York would shift from a $4 billion surplus to a $2.5 billion deficit.

That is an amazing finding. When a 15 percent decline in revenue more than doubles the number of nonprofits with deficits and results in a loss of $6.5 billion in net income, then something is very seriously wrong. If true, nonprofits in New York appear to be living on a financial knife's edge. The merger or consolidation option would appear to be much more than academic.

> "Deals often look more exciting from the outside. We had a story about this back in Iowa. A man found that his horse was ailing. So he took the horse to the vet and asked, 'Can you help me? Sometimes my horse walks fine. But other times, he limps.' The vet looked at the horse and said, 'Yes, I think I can help you. When he's walking fine, sell him.' That's a good thing to remember in the merger market. The buyer must always beware."
>
> —James D. Ericson,
> Chairman and CEO, Northwestern Mutual

For New York's nonprofits, change may be more than good. It may be the stuff from which survival itself is made.

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The Growing Demand for Philanthropic Accountability: Will There Be Room for Risk?

With growth in philanthropic roles in American society, and with greater media awareness of instances of philanthropic mismanagement, there is growing demand for organizational accountability within the philanthropic sector. In turn, there is an expectation that funders be as cognizant of the need to produce both efficiency and impact as their nonprofit grant recipients.

This is not news. Numerous observers have pointed out that foundation accountability is problematic. Beyond their board members, foundations are not subject to the scrutiny of either the market place or public regulation. There is no market measure determining whether they spend their money well or ill. As a consequence, there has been a growing call for the functional equivalent of benchmarking among foundations. Led in part by the W.K. Kellogg Foundation and the David and Lucile Packard Foundation, this effort has attempted to achieve consensus among foundation leadership that measuring effectiveness is important and that unanimity be reached on the methods to be used for such measurement.

"Great deeds are usually wrought at great risk."
—Herodotus

The 2002 conference of Grantmakers for Effective Organizations devoted considerable attention to the impact and accountability issues, including the application of performance measures to foundations. The conference report makes for an interesting read. Although "effectiveness" often does not equate with impact, certainly, the ideas of effectiveness and accountability receive applause.

Two issues remain troubling, however. One emerges from observations that are in the report, one from an issue omitted.

Grantmakers at the conference were asked to rank "current reality" and "desired future" along a spectrum for a series of 13 issues. Understandably, grantmakers' average scores for the desired future diverged from their assessment of current reality. But the two issues on which grantmakers felt that current reality was closest to optimal were "regulatory requirements for philanthropy" (understandably, since few industries of any type seek to be more aggressively regulated) and "results-based accountability." Grantmakers on average portrayed the current importance of results-based accountability as being almost the desired importance. This does not seem to reflect a burning desire to explore new worlds of benchmarking among the philanthropic rank-and-file. There would appear to be a difference of perspective between the enthusiastic comments of leaders in the report and the views of those who would follow.

The more difficult question posed by the application of benchmarking or performance measurement to philanthropy however, does not appear in the report. I am a firm believer in rigorous accountability and merciless evaluation, but, when applied to foundations, what happens to risk?

"There are risks and costs to a program of action. But they are far less than the long-range risks and costs of comfortable inaction."
—John F. Kennedy

In part because they are endowed and independent, philanthropies have the capability to explore new frontiers. They have the capability to identify promising innovations, untested approaches, and blasphemous theories, and to place bets (well-educated bets, hopefully) on these novel solutions. They have the capability to be society's risk-takers. Where private enterprise must minimize risk to ensure return, and where government must beware of risk in its role as the guardian of the taxpayers' purse, foundations can seize risk. The daycare provider with the novel approach to reaching undocumented workers, the laboratory with the preclinical insight that is too early for National Institutes of Health (NIH) consideration, the teacher with the caution-to-the-wind inspiration about how biology really ought to be taught—none of these will find funding through conventional public sources, nor through market-sensitive private enterprise.

Yet, because they are untested and therefore risky, such opportunities are also likely to suffer a higher rate of failure than conventional approaches. If a foundation's role (at least in part) is to explore the novel, then it must also be expected to fail. Indeed, there is a case to be made that any foundation grant portfolio without a healthy proportion of failures is not taking enough risk; it is simply substituting philanthropic money for government or market money, hence is not fulfilling its societal role.

But, if we are to apply performance and effectiveness standards to foundations, what shall we do with risk? There is no "reward" to risk in philanthropy comparable to the market reward that provides incentives to risk. The reward is only in the consistency with the larger mission of foundations. So, if there is not reward, and if risk is avoided in the interests of performance, who (except the MacArthur Foundation's "genius" grants) will fund the blasphemers, the innovators, the revolutionaries?

Further, will the coming transfer of wealth and the growing reliance on philanthropy for the funding of basic services add propulsion to the evaluation-sensitive, risk-averse momentum of foundations? Where resources are increasingly consumed by grants for basic services, and where the needs of such services exponentially exceed the resources available, will innovation, insight, inspiration—hence, risk—be further avoided?

As ardent abolitionist and Fireside Poet James Russell Lowell put it, "Not failure, but low aim, is the crime."

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Managing through the Market: Responding to Severe Economic Cycles

The October 11, 2002 edition of the *New York Times* made quite an issue of the effect of Wall Street's "Blue Period" on philanthropic capacity, and the hard times that the philanthropic response promises for nonprofits. Gloom and doom is the bread and butter of the news business, so one should not be surprised that the article found bits of the sky scattered about the landscape. But, skeptic that I am, let's look more closely at the numbers and their implications.

> "Wall Street indexes predicted nine out of the last five recessions."
>
> —Paul A. Samuelson, 1966

First of all, from the point of view of the nonprofits. It is certainly true that a rise in the number of nonprofits and an inflation-adjusted decline in charitable dollars has constrained the total resource base for nonprofit funding (more on this later). And, of course, that is particularly true for any nonprofit that bet the ranch on one or two frisky technology thoroughbreds whose legs gave way in the back stretch. All betting entails risk, and, often, risk wins.

But, by and large, U.S. nonprofits are smarter than the *Times* gives them credit for being. Nonprofits do diversify their revenue streams. A 2002 report by the New York City Nonprofits Project of the Nonprofit Coordinating Committee of New York indicates that foundation and corporate grants accounted for only 5 percent of the revenue sources of New York City nonprofits. In comparison, 25 percent came from government grants and 37 percent from service fees and sales. Of course, there are differences by sector, with the arts overwhelmingly more dependent on grants. Still, even there, grants accounted for only 23 percent of receipts; when individual donations were added, the total was 40 percent, making that sector notably vulnerable. But human services organizations relied on individual donations and foundation grants for only 13 percent of their revenue. The point is, if the sky is falling, it is falling only selectively.

How about from the point of view of foundations? It is absolutely true that many foundations have seen endowments erode. How much is a function of their investment strategy over the last (at least) three years. Then again, the erosion and its link to investing choices is not unique to the world of philanthropy. Most Americans with Individual Retirement Accounts have experienced little financial joy in the last several years.

The endowment erosion of foundation assets raises management issues. How does one manage around the realities of business cycles? The article provided two examples, but did not "do the math" that illuminated their implications. By doing that math (arithmetic, really), the effects of management choices become clear. Doing the math reveals two alternative approaches to market-driven change. One foundation saw its assets erode by 80 percent, the other by 36 percent. Neither, to its credit, reduced its grantmaking at a pace equal to its assets. That is where the similarity ends.

The foundation with 80 percent erosion reduced its grant level by 20 percent and its staff by 50 percent. The result was a net increase in grant resources allocated per staff member. In turn, this implies a decrease in the cost of doing business and an increase in productivity. The second, with 36 percent erosion, reduced its total grant resources by 9 percent, but cut its staff by only 3 percent. The result was a net decrease in grant output per staff member—implying, in turn, an increase in the cost of doing business and a decrease in productivity. Further, in the 80 percent case, with an increase in money moved per staff member, the absolute level of grant dollars per staff member ($2.5 million) was over three times that of the foundation with 36 percent erosion (just over $800,000).

These simple calculations probably understate the differences in impact on the cost of doing business between the two examples. In the 36 percent erosion case, 74 percent of the eliminated positions were in the developing world. If at least part were local salaried personnel, then reduction in costs was not parallel with an equivalent impact on reducing U.S.-level compensation.

So the more interesting questions about severe market cycles and philanthropy are about the management strategies that maximize the money flowing from the foundation spigot.

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The Philanthropic Instinct: Government Walks the Talk

The close relationship between government and the nonprofit sector is neither new nor news. At its most basic level, the growth of the nonprofit community is, at least in part, a product of government policy, especially tax policy. In addition, however, government is a major source of nonprofit revenue. Grants, contracts, and reimbursements from public agencies provide the nonprofit sector with 36 percent of its revenue. For civic affairs organizations, that portion rises to 51 percent and for healthcare, 41 percent.

Although government funding has had its ups and downs over the decades, since the late 1970s government support for nonprofits has risen an average of 6 percent per year.

The success of the nonprofit sector, and the concomitant growth in private philanthropy supporting that sector, however, have not been lost on government agencies. The government itself has recently entered the philanthropic world, and entered it at its heart—as a fundraiser for its own programs!

For years, of course, local public agencies, notably fire departments and sheriff's offices, have established independent foundations for community donations to support public safety services. In a few instances, local or county public service agencies have also established foundations to raise supplemental funds for their programs. For example, the Craven County Health Department Foundation in New Bern, North Carolina, reported just over $51,000 in income to support county public health programs.

But the urge to fundraise has leapt across the equivalent of governmental species. The federal government now shares the philanthropic itch. Taking a page from its local public and voluntary agencies, and banking on the success of private philanthropy in the go-go 1990s, the federal government has now begun to encourage private fundraising to pursue its agenda. Foundations and other funds affiliated with federal agencies and quasi-agencies are pursuing philanthropic donations from individuals, corporations, and foundations. The Centers for Disease Control (CDC) Foundation, for example, was founded in 1994 to "champion . . . initiatives" of the Centers for Disease Control and Prevention of the U.S. Department of Health and Human Services. For the fiscal year ended June 2000, the CDC Foundation reported nearly $5 million in revenue and $12 million in net assets.

The National Academy of Engineering (NAE) Fund, established to supplement the work of the NAE (which carries out scientific and technical analyses for the Congress and executive agencies) reported $10.4 million in operating revenue for 2000, of which about $8 million was from private contributions and $2.35 million was from income on its $58.4-million asset base of investments and securities.

Of course, the federal fundraising granddaddy of them all is the Library of Congress, which, after a specific act of Congress, was permitted to receive its first private monetary gift in 1909. The Library of Congress Trust Fund was created in 1925, with authority to accept and invest gifts. With the opening of its development office in 1987, and a fundraising Web site in 1998, the trust fund is setting new precedents for its federal philanthropic counterparts.

There are, perhaps, two ways to look at this trend. Raised eyebrows is certainly one option. These are, after all, public institutions, accountable to the public, via democratically elected representatives, for their policies and programs. If the electoral process results in an expression of public support for (or lack of support for) particular efforts or directions, then the financial expression of that view is meted out in the budgetary process allocating public funds. Diversification of programs into areas of private interest and/or supplementation of public funding with privately interested resources might give the purist pause.

That caution would be deepened for those in the nonprofit world who might see such fundraising as competition for finite philanthropic dollars. How can a local health nonprofit compete for donations for prevention programs, when the private fundraising competition is the federal government?

Conversely, a hearty "bravo" is the second analytic option. Taking the easiest criticism first, there are no data that portray philanthropy as a zero-sum game. What one nonprofit gains does not equal a loss for another. Rather, the consistent growth in philanthropy would indicate that philanthropy is a positive-sum game (i.e., every fundraising gain has the potential to increase the total philanthropic pie by encouraging additional new giving from elsewhere). In that sense, the power of a major player (e.g., the federal government) in the philanthropic marketplace might increase awareness of prevention needs, hence motivate local philanthropy to become more supportive of local efforts.

That said, is private philanthropic fundraising by public agencies appropriate? It is true that one can think of scenarios in which raised eyebrows would be justified. Money talks. There is as much opportunity for horse-trading of dollars and programs in the nonprofit world as in the corporate boardroom. The risk is always troubling, and it is doubly troubling where the public trust is an organization's raison d'etre.

The answer to that concern, of course, is not prohibition, but transparency. It is key that private fundraising organizations dedicated to supplementing the resources of public agencies be transparent. Fortunately, the quintessential American combination of the Internal Revenue Service, energetic national watchdog organizations, and a lively press corps give hope that transparency will prevail. Indeed, transparency will be more likely for these agency-support foundations than anywhere else in the nonprofit world. After all, they shadow federal agency efforts, and those agencies answer to the electorate. Where the electorate is to be found, there also will Congress be found. Nothing encourages the straight and narrow like the potential for being called before the House or Senate.

Besides, it's a free country. One of the first philanthropic donations in America at its infancy was from Benjamin Franklin in 1789. He handed his money not to some nonprofit, but to the City of Philadelphia. If Joe and Jane Taxpayer are fond enough of the work of the government that they want to supplement their tax bill with an additional donation, then caveat emptor.

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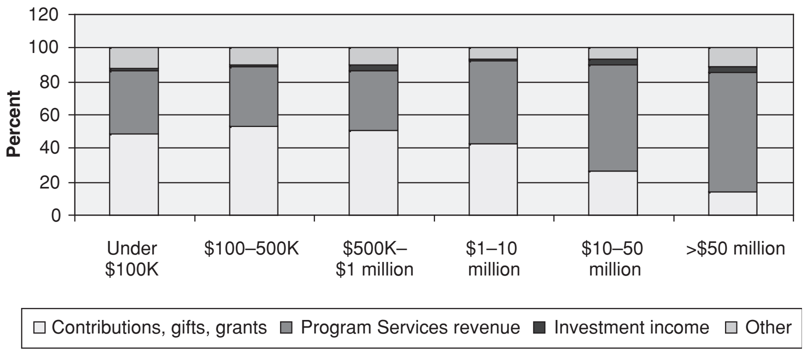
Does Wall Street Matter? The Unknowns about Elasticities

Nonprofit private charities are, it is said, so heavily dependent on revenues from the private sector that the dip in the Dow equates to a Maalox moment for nonprofit budgets. How true is that? There are three ways to look at the problem.

First, and most directly, there is the question of the direct relationship between the revenues of charitable nonprofits and their assets. An IRS sample of 162,559 charitable nonprofits' balance sheets illuminates the issue. Overall, revenue from investments, sales of securities, and sales of other assets (including rent) amounted to just 4.1 percent of revenue. For nonprofits with assets under $1 million (two-thirds of the sample), it accounted for under 1 percent. So, for all but the largest charitable nonprofits swings in the Dow have little direct bearing on the balance sheet. Even for the largest nonprofits—those with assets of greater than $50 million each—income from investments and assets rarely exceeds 4 percent of total institutional revenue.

Second, the two most important sources of nonprofit income are government grants and service revenues. Together, these account for over three-quarters of the income that funds nonprofit budgets. The effect is more pronounced for extremely large charities (with assets of over $50 million) for which nearly 80 percent of revenue is attributable to service sales and government. In the smallest charities, however, these two sources also account for over 50 percent of revenues. So, to the extent that the Dow reflects a

EXHIBIT 1.12 SOURCES OF NONPROFIT REVENUE, 1999, BY ASSET SIZE



Source: Internal Revenue Service (Arnsberger)

broader economic downturn (which is not always the case), then it matters not so much in terms of the market value lost in the dip, but the reduced tax support for government budgets and the purchasing power of consumers. That means for the heart of the nonprofit charity's budget capacity, it is not the Dow that matters but the economy. The tax take in Washington matters more than the price-to-earnings ratio on Wall Street.

Third, it may also be true that contributions by the public to nonprofits are affected by the Dow, but only insofar as contributions are made out of gains from assets represented by the Dow. Foundations make such contributions because they give from endowment earnings, but foundations are only 10 percent of all philanthropic giving in the nation. Individual behavior is more important. Do individuals give out of assets or out of income? If the former, then the Dow clearly matters. But most quotidian giving is not a result of the sale of assets, so the value of those assets is not a driving force.

> "We make a living by what we get, but we make a life by what we give."
>
> —Winston Churchill

If giving is out of income, then, again, it is the economy that matters. And, as with the market for sale of services by nonprofits, the issue for contributions behavior relative to income is akin to what economists call elasticity. This is an interesting question about which little has been written. Elasticity measures the relationship between price and demand or price and supply. If demand does not respond to changes in price, then it is said to be inelastic. The question, then, is how to measure the elasticity of individual giving.

If the economy stumbles and incomes decline (or people perceive that their income declines), how much decline must occur before giving also declines? Alternatively, for every dollar of decline (or perceived decline), how many cents of giving are withheld? Does income level matter? Does place matter? Does age matter?

> "Medical science has developed two ways of actually determining insanity. One is if the patient cuts out paper dolls, and the other is if the patient says: 'I will tell you what this economic business really means.'"
>
> —Will Rogers

This metric is important for two reasons. First, of course, it is important because it allows organizations to plan. Having some sense of elasticities would allow charities to anticipate revenue constriction in advance, and plan accordingly. In turn, planning prevents unnecessary handwringing through economic cycles, and, in turn, unnecessary public expressions of alarm over giving levels.

Understanding elasticities is also important because it would provide a more accurate and realistic picture of the American philanthropic impulse. Most research treats philanthropy as a stock. It measures amounts given annually just the way a warehouse measures widget inventory: "$300 billion of goodwill delivered in 2001." But philanthropy is not a stock; it is a flow. It is not widgets; it is finance. Giving is the monetized value of a stream of behavior by individuals. That stream has a course and a depth, and it flows with currents and eddies whose physics are determined by the obstacles in its path. Thinking about philanthropy as a flow rather than a stock would lead to a better understanding of all of those factors—and, in turn, a better understanding of and ability to predict future trends.

Why bother? Because the more the nation relies on individual initiative and behavior to resolve societal problems, the more the understanding of that behavior will be important. If we are to turn to individual giving and volunteering as a solution, we must forge strategies from accurate information, not from common wisdoms.

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