Chapter 1

The Disheartening Problem of "Scale"

Philanthropy today generates a world in which experiments multiply but very little sums.

—*Katherine Fulton and Andrew Blau, "Cultivating Change in Philanthropy"*

Anyone in search of the very model of the modern social enterprise need look no further than Teach For America (TFA). Wendy Kopp founded TFA in 1990, and the title of her book about that adventure, *One Day, All Children*. . . , encapsulates in just four small words what is so important about the social movement TFA represents:

> As a college senior, I happened upon an idea that would put me in the middle of an incredible movement. The idea was to create a corps of top recent college graduates—people of all academic majors and career interests—who would commit to teach two years in urban and rural public schools and become lifelong leaders dedicated to the goal of educational opportunity for all.[1]

Just 21 years old at the time, the estimable Ms. Kopp didn't just want to help a lot of kids in underperforming public schools, she wanted to help *all* of them. She envisioned creating "an enduring American institution" that would "eliminate educational inequality," the socioeconomic and racial disparities that "severely limit the life prospects of the 13 million children growing up in poverty today."[2] And so TFA dedicated itself to the proudly audacious proposition that "one day, all children in this nation will have the opportunity to attain an excellent education."

The problem of educational inequity is no small matter, as virtually all recent studies confirm. Douglas Harris of Arizona State University's Education Policy Studies Laboratory calibrated the differences among high-performing schools for different socioeconomic cohorts:

> The achievement gap between students of various racial, social, and economic groups is large and growing. For example, between whites and African-Americans, the size of the achievement gap ranges from 29 to 37 percentile points. Between whites and Hispanics, the gap is 16 to 34 percentile points. Strong signs suggest these gaps have worsened recently after decades of improvement.[3]

Such pervasive and enduring disparities do not originate from simple or ephemeral causes. Rather they reflect the corrosive effects of long-term institutional and systemic failures:

> All parts of the political spectrum seem to agree that these educational inequities represent a significant problem. There is also strong evidence and agreement that students' social and economic disadvantages are substantial causes of the problem. Poor nutrition and illness cause students (a) to miss school more often and (b) to be less prepared to learn when they attend. Within the disadvantaged home, parents often have relationships with their children that are, emotionally and physically, less healthy. These unhealthy relationships are reinforced in part by economic pressures that induce conflicts between parents and children. The combination of these factors and other effects is shown to be worse as students remain in poverty for longer periods of time. Of course, many parents living in poverty are able to successfully navigate and avoid these potential problems, and some parents with high incomes are not great parents, but the general patterns described here are quite strong.[4]

Andrew Sum, director of Northeastern University's Center for Labor Market Studies, puts it more simply: "Declining economic fortunes of young men without college degrees underlie the rise in out-of-wedlock child-bearing, and they are creating a new demographic nightmare for the nation."[5]

The gravity of the situation makes TFA's accomplishments over the past 17 years all the more extraordinary. A 2004 independent research report found that "even though Teach For America teachers generally lack any formal teacher training beyond that provided by Teach For America, they produce higher test scores than the other teachers in their schools—not just other novice teachers or uncertified teachers, but also veterans and certified teachers."[6] Another study concluded that "nearly three out of four principals (74 percent) considered the Teach For America teachers more effective than other beginning teachers with whom they've worked" and "the majority of principals (63 percent) regarded Teach For America teachers as more effective than the overall teaching faculty, with respect to their impact on student achievement."[7] Most recently, a 2008 study found: "TFA teachers tend to have a positive effect on high school student test scores relative to non-TFA teachers, including those who are certified in-field. Such effects exceed the impact of additional years of experience and are particularly strong in math and science."[8]

More than 17,000 "corps members" have joined TFA since 1990, and they've reached more than 2.5 million kids in more than 1,000 public schools nationwide. TFA plans to more than double the number of corps members from the year 2005 to 2010, from 3,500 to 7,500, and to increase its placement sites by 50%, from 22 to 33.[9]

Remarkably, TFA recently eked out tenth place in *Business Week*'s "The Best Places to Launch a Career," and it recruits more college seniors than Microsoft, Procter & Gamble, Accenture, or General Electric.[10] The once famously shy Ms. Kopp is so dedicated to her cause that she not only appeared on Comedy Central's *The Colbert Report*, but she mopped the floor with the pugnacious satirist.[11]

Notwithstanding these impressive achievements, there is one measure of success that TFA has not met: its own. TFA's success is impressive except in comparison to the universe of need embodied in the phrase, "one day, all children." After 17 years of perseverance, the 425,000 students TFA plans to reach in 2008 represent just 3.3% of the 13 million kids who face "educational inequity."

As far as I know, TFA has no specific plans by which it will reach 13 million disadvantaged students. Nor, for that matter, does any other social change organization of which I'm aware.

For example, the NewSchools Venture Fund, another proud flagship of the nonprofit entrepreneurial fleet, is dedicated to "promoting high academic achievement for every child by attracting, preparing, and supporting the next generation of outstanding leaders for our nation's urban public schools."[12] Since 1998, NewSchools has raised and deployed tens of millions of dollars for educational innovation at dozens of charter-management and school-support organizations. It states that "over the next several years, the organizations we support will run more than 200 charter schools and serve nearly 75,000 students, making NewSchools' national portfolio comparable in scale to a mid-sized urban district."[13] After 10 years of exceptional work and highly sophisticated financial management, the aggregate result (at least of the charter school portion of its portfolio) amounts to one school district that performs at the level to which the entire country aspires.

"All Children"

Social entrepreneurs "carry out innovations that blend methods from the worlds of business and philanthropy to create social value that is sustainable and has the potential for large-scale impact."[14] But for all that social entrepreneurs such as TFA and NewSchools have accomplished, they have yet to come to grips with the implications of their worthy goal of helping "all children" in need. While quite a few successful and innovative nonprofit organizations (NPOs) aspire to serve millions of people who need their services, I've yet to see even one strategic growth plan that explains how the organization will address anywhere close to even 20% of the need.

A comparison of what social entrepreneurs call "scale" and what I'll be calling "transformative social impact" puts things into perspective. Social entrepreneurs (and their "venture philanthropy" funders) appropriately identify organizational growth as one of their fundamental strategic objectives, and after a decade or so of hard slogging, they take justifiable pride in what they've accomplished.

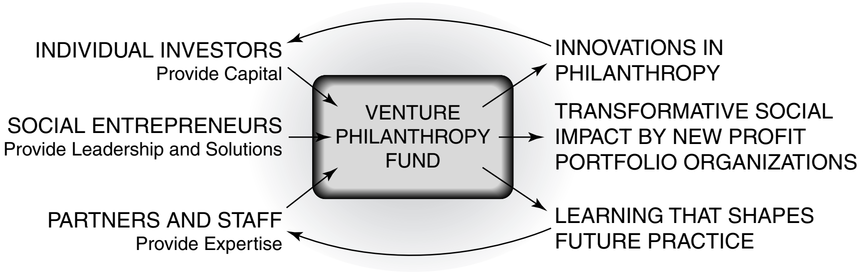

Exhibit 1.1 New Profit, Inc. Model of Venture Philanthropy
Source: "Our Model of Venture Philanthropy," New Profit, Inc., 14 Apr. 2008, www.newprofit.org/about_model.asp.

For example, New Profit, Inc. (NPI) in Cambridge, Massachusetts, was one of the original venture philanthropies that adopted a funding approach modeled after venture capitalism in order to alleviate many of the shortcomings inherent in traditional foundation financing. NPI devised a novel funding and support model (see Exhibit 1.1) that integrated the efforts of investors, social entrepreneurs, business consultants, and other experts to nurture and grow portfolio NPOs to an extent that had not been possible under the more passive foundation model.

Venture Philanthropy Partners (VPP) in Washington, DC, also provided innovative social entrepreneurs with funding tailored to their more businesslike approach to social change (see Exhibit 1.2). Like NPI,

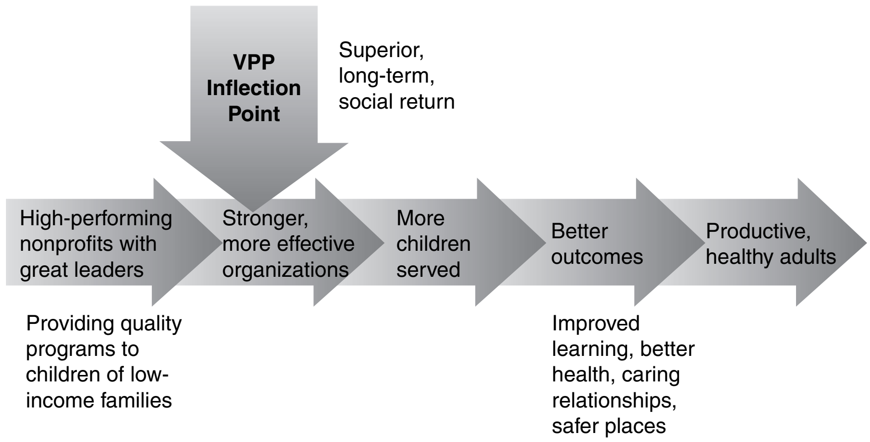

Exhibit 1.2 Venture Philanthropy Partners' Value Chain for Institution Building
Source: "Future Impact," Venture Philanthropy Partners, 17 Sept. 2007, www.vppartners.org/impact/future.html.

VPP made larger, longer, and more flexible grants to carefully selected nonprofits and provided in-kind management consulting to help their portfolio NPOs enhance organizational capacity and effectiveness.

The traditional model of nonprofit finance that venture philanthropy sought to reinvent is deceptively simple: foundations collect charitable contributions and bequests from individuals, corporations, and institutions, and they administer systems of grant application, review, and funding to NPOs that the foundations believe will advance their social missions. But entrenched historical, practical, and structural problems have come to plague foundation funding:

Fragmentation and Undercapitalization

Traditionally, "[f]oundations saw their role as funding a large number of small programs for a short time, hoping that a few would enjoy some initial success."[15] As a result, it has become a regrettable fact of nonprofit life that "[f]oundations generally spread their resources—both money and people—too thin."[16] "The average grant among the 100 largest foundations is roughly $50,000."[17] Such grant sizes are simply too small to support the development of robust and enduring nonprofits capable of achieving scale and consequential social impact, and foundation employees are responsible for too many grant applications to provide active or sustained engagement with recipients beyond simple financial support. More than 90% of U.S. nonprofits have annual budgets of less than $1 million, and fewer than two dozen social entrepreneurs have annual operating budgets exceeding $20 million.[18] As a result, "a foundation grant covers only a small proportion of a nonprofit's costs."[19]

As one trenchant example, *Business Week* reported that the $1.6 billion Annenberg Challenge was "widely viewed as a crushing disappointment." The reason: "The five-year grants, sprinkled across a range of initiatives in New York, Chicago, and 16 other cities, were too diffuse to have much impact."[20]

Time Horizons

Compounding the grant-size problem, foundations generally assess their own grantmaking performance on a quarterly basis, and 95% of all foundation grants are for just one year (subject to reapplication for subsequent funding).[21] The duration of grants is driven primarily by institutional guidelines, rather than collaboration with applicants or an assessment of whether the length of the grant is commensurate with the time required to accomplish the nonprofit's objectives.[22] The system "has led to foundations' time horizons being out of sync with those of their grantees, which are trying to build organizations that can sustain programs."[23]

Distraction

The inevitable result of the size and duration constraints is the "tyranny of the grant cycle":[24] nonprofit executives devote an absurd amount of essentially unproductive time to continual and unrelenting fundraising. Clara Miller, CEO of the Nonprofit Finance Fund, observes that "nonprofits, almost by definition, run two businesses—the core, mission-oriented business, and a second 'subsidy' business or businesses." The length and breadth of such activities that have nothing directly to do with achieving the NPO's objectives would sap the strength of the most lion-hearted private-sector CEO: "[s]ubsidy businesses include fundraising, dinner dances, special events, bingo, the capital campaign, for-profit related and unrelated businesses (bookstores, gift shops, parking lots), donated services, wine and cheese parties, endowment management, and any number of creative fundraising ideas long a staple of the sector."[25] In fact, fundraising diverts management attention from mission-related activities to such an extent that it has become a primary source of burnout and excessive turnover among experienced nonprofit leaders.[26]

Grant Restrictions

Traditional foundations have an anaphylactic aversion to paying administrative overhead expenses, viewing them as "costs that divert precious resources from the real work of delivering programs."[27] To insure that grants benefit disadvantaged populations directly, rather than the nonprofit equivalent of "bureaucrats" in what foundations perceive as uncertain start-ups, funders "prefer working with well-established organizations or restrict their giving to programmatic support."[28] Not only do such restrictions deprive NPOs of needed support for the enterprises through which nonprofits carry out their work, but restricted grants and contracts that fund program expansion often create additional expenses or cash requirements that the funding does not fully cover.[29]

Transaction Costs

As a result, nonprofit financial markets are highly disorganized, with considerable duplication of effort, resource diversion, and processes that "take a fair amount of time to review grant applications and to make funding decisions."[30] It would be a major understatement to describe the resulting capital market as inefficient. McKinsey & Company found that, while for-profit companies spend only $2 to $4 for every $100 of capital raised, nonprofits spend between $10 and $24 to acquire the same $100. When the administrative costs of foundations, federated givers such as the United Way, and government grantors are factored in, "the cost of raising capital consumes roughly 22 to 43 percent of the funds raised."[31] Such a system significantly reduces potential social impact well before charitable contributions find their way to NPOs.

In June 2008, REDF (formerly the Roberts Enterprise Development Fund) published a brilliant paper by Cynthia Gair, "Strategic Co-Funding," the first of three that will comprise a series entitled "Out of Philanthropy's Funding Maze."[32] Gair's comparison of two hypothetical investment scenarios, one for-profit and one nonprofit, perfectly captures the absurd carnival that passes for the social capital market:

> Three years ago, Janet Schmidt started her solar energy company, Solar-Jay. She and her team have developed a unique product and a growing customer base. What they're doing works and it's time to expand. Janet contacts Fred Malcolm at Green Cap LLP, a venture capital firm known for its investments in early-stage, green-technology companies. Fred reads the Solar-Jay business plan, meets with Janet, and decides the business has great promise. He assesses the potential for a high-return acquisition of the firm and estimates that Solar-Jay may need twice the $5 million investment it seeks, to reach its profit targets. Since Green Cap can only commit to a $3 million investment, Fred calls up two friends who are partners at nearby VC firms. Three months later, after discussions, due diligence, and some business plan revisions,

> Green Cap and Solar-Jay agree on final terms for the investment. Fred joins the company's board, Solar-Jay receives its initial cash infusion, and expansion plans are set in motion.
>
> A few miles away, Ed Baker runs StepUp to Solar, Inc., a nonprofit that helps runaway teens stabilize their lives by engaging them in environmental education and jobs in the growing solar panel installation field. In the eight years since Ed founded the organization, the program has developed a good track record with the teens it serves and with community funders. It has demonstrated tangible, positive outcomes. Solar panels are catching on and more youth need jobs, so Ed and his board would like to expand. They calculate that it will take a one-time, $1 million upgrade of infrastructure plus an annual $300,000 increase in operating costs. Ed and his development manager start contacting potential funders. After six months—and 36 phone calls, 13 funding proposals, six meetings with commercial banks, 18 conversations with local and national foundations and city government departments—two foundations have committed to grants totaling $55,000. Proposals are on hold with two foundations that are undergoing strategy changes. Five foundations have rejected StepUp's proposal because the program is not new. A city department is eager to refer youth to StepUp's expanded program, but will not be able to fund the expansion unless it takes on a technical training focus. Ed calculates that in a best-case scenario, StepUp may receive $700,000 of the $1 million needed, but the expanded reporting requirements from these funding sources will add $50,000 to StepUp's annual operating costs, which no one appears ready to fund. Given these results, StepUp's board is uncertain about approving any expansion at all, but Ed and his team go back to the drawing board to calculate the costs of a reduced plan.

To overcome these serious and long-standing deficiencies, both NPI and VPP borrowed heavily from venture capital approaches to selecting, funding, and supporting promising nonprofits that they believed could achieve the "one day" visions they all shared (see Exhibit 1.3).

The venture philanthropy model has amply demonstrated its ability to significantly accelerate nonprofit growth trajectories. For example, from 1999 through 2005, the NPI portfolio achieved 29% compound annual revenue growth and 42% compound annual growth in "lives touched." Both figures substantially exceeded rates for comparable

Exhibit 1.3 New Profit, Inc. Graduation Standards

Attribute	**Standard**
Organizational Competencies	Robust, strategically focused management team.
	Key leadership positions have a succession plan in place.
	Performance-based culture is in place throughout the organization.
	Results are quantified using Balanced Scorecard.
Mission and Social Impact	Proven results tell a compelling social impact story.
	Growth model of the organization is sustainable.
	The organization is mission-focused and able to prevent mission drift.
	The organization is recognized as a leader in the field.
Financial Sustainability	Performs regular, effective forecasting of revenue and expenses.
	Distinguishes between growth capital and revenue.
	Maintains ample working capital and contingency funds.
	Diversified funding base with major funders aligned around growth priorities.
	The organization has a clear understanding of cost per incremental life touched.

Source: Robert S. Kaplan and David P. Norton, *The Balanced Scorecard: Translating Strategy into Action* (HBS Press 1996). Adapted from "Citizen Schools' Growth with High-Engagement Funders," New Profit, Inc., 2004

nonprofits.[34] Likewise, Venture Philanthropy Partners estimates that the number of children its investment partners serve will increase from 44,000 in 2007 to more than 80,000 by 2010.[35]

Consider the year-over-year growth of two organizations in the New Profit portfolio. College Summit, which helps low-income students matriculate and succeed in college, has multiplied the number of students reached by about 700% in five years, and it hopes to nearly double in size in 2007–2008.[36] Jumpstart, which helps poor and low-income children enter school prepared to succeed, has also increased the number of children served to about six times the level it achieved just six years ago.[37]

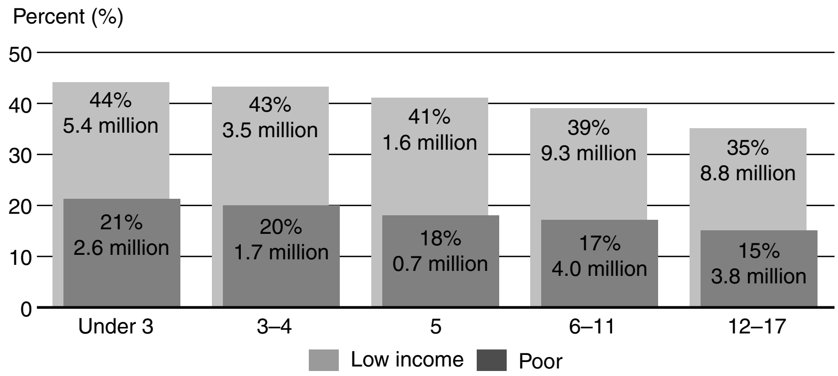

Exhibit 1.4 Children Living in Low-Income and Poor Families, by Age Group, 2006

Source: Ayana Douglas-Hall and Michelle Chau, "Basic Facts About Low-Income Children: Birth to Age 18," National Center for Children in Poverty, Mailman School of Public Health at Columbia University, 14 Apr. 2008, www.nccp.org/publications/pub_762.html.

"One Day"

Regrettably, the national dimensions of the problems on which these intrepid entrepreneurs focus their considerable energies dwarf their genuinely impressive accomplishments. As a sobering baseline, consider that in 2006 there were 28.3 million low-income children aged 17 and below in the United States (comprising 39% of the total 73 million children), of whom 12.8 million were poor (see Exhibit 1.4).[38]

Viewed from this humbling perspective, the absolute numbers of children helped by these admirable organizations barely comprise, to use a familiar metaphor, a drop in the bucket (see Exhibit 1.5).

As we consider the current state of American social progress, we need to recognize just how far away "one day" really is likely to be under the most optimistic assumptions. Even at double-digit annual growth rates, it will take many years for social entrepreneurs and their funders to address even 10% of the populations in need. While we rightly celebrate the advancements that social entrepreneurship and venture philanthropy represent, the eminent nonprofit scholar Peter Frumkin reminds us that we have to look to the horizon with a clear eye:

> It remains very difficult, however, to see how the many small and isolated success stories of donors around the country ever amount

Exhibit 1.5 Percentages of Need Served by Leading Social Enterprises.

Organization	Focus	Served per Year	Total Need	% of Need
BELL	Out-of-school time	8,000	10,800,000	0.07%
College Summit	College access	1,300	200,000	0.65%
Jumpstart	School readiness	13,000	3,300,000	0.39%
Raising a Reader	Infants to 5-year-olds	200,000	10,100,100	1.98%
Teach For America	"Educational inequity"	425,000	13,000,000	3.30%
Year Up	"Disconnected youth"	350	3,800,000	0.09%

Source: Based on data from Web sites of organizations listed.

to anything vaguely resembling a meaningful response to any of the major social problems—be it economic development in the inner city, access to health care, reduction in youth violence, or reform of public schools—that private philanthropy has long targeted.[39]

Transformative Social Impact

This is not a knock on social entrepreneurs or any other nonprofit. To the contrary, successful social entrepreneurs, venture philanthropies, and other funders have accomplished something extraordinary. They have figured out real solutions to long-standing social problems of the most serious kind, including:

- Helping disadvantaged kids reduce the educational achievement gap
- Placing disconnected youth in entry-level technology jobs with major corporate employers
- Bringing nontraditional leaders into failing public schools
- Increasing college enrollment and graduation rates
- Enhancing parental involvement in their children's education

- Increasing minority participation in top MBA programs
- Creating thousands of homegrown small businesses in developing countries to reduce poverty

Just as important, they have built enduring organizations to deliver those solutions over an extended period of time, replicated those delivery systems at multiple sites while maintaining high levels of quality, and accomplished rates of organic growth that most private sector companies would envy.

These are not small accomplishments. In fact, figuring out and delivering the core solution to our most stubborn social problems, such as reducing dropout rates and increasing teaching effectiveness, just might be the hardest part of the puzzle. But while social entrepreneurs have established thriving base camps, it must be acknowledged that something fundamentally different will be required to extend their impacts by the orders of magnitude needed to transform their small-scale successes into transformative solutions to national problems.

Turning those drops into rivers won't be easy, but I believe it can be done. Now that these pioneers have begun to unlock these previously unyielding obstacles, it would be unforgivable for others of us not to step up to help on this next set of challenges.

I certainly do not fault social entrepreneurs for thinking about how to help "only" tens of thousands of disadvantaged people, rather than millions. If anything, the growth plans they've crafted are a testament to the seriousness of purpose and level-headedness of the leadership teams of these business-minded organizations. While the new wave of nonprofit leaders are certainly tenacious, they haven't taken leave of their senses altogether. It is one thing to plan, say, 25% annual growth, or even tripling or quadrupling in size in, say, five years; it is quite another to announce your intention to become 10, 20, or 100 times bigger in the foreseeable future than you are today. How could anyone explain—with a straight face, anyway—how and where they would find the money and the people to build and manage all the programs and sites that would be needed to accomplish such a bizarrely audacious objective?

However, social entrepreneurs do sometimes indulge in what I consider unrealistic and amorphous notions about avenues for growth, such as other nonprofits emulating and extending their work, and increased government funding. Such thinking reminds me of a favorite *New Yorker* cartoon in which two academic types stand in front of a blackboard on which two batches of complex equations are separated by the phrase "then a miracle occurs." One says to the other, "I think you should be more explicit here in step two."[40]

Although expectations of emulation and increased government funding undoubtedly have some validity, neither faces up to the nature or difficulty of the problem realistically:

> Being effective means more than just carrying out an initiative well and meeting the needs of a small group of people. Effectiveness also involves reaching many people and taking the social leverage that an intervention creates and amplifying it even more broadly. Given the interest in having a real impact, donors speak variously of taking programs to scale, going to scale, and scaling up. The idea of scale focuses on creating a lasting and significant impact. Beyond the broad idea of greater impact, the idea of scale becomes more enigmatic when it is subject to sustained scrutiny.[41]

I do not mean to suggest that Teach For America's mission to help "all children" is grandiose or unreachable. To the contrary, I think the scale of its ambitions is exactly right, and I have every confidence that TFA can fulfill its mission. As a nation, we can't accept anything less. However, I don't think TFA or any of the other pioneering nonprofits that have galvanized the sector in recent years can do so within the growth models that are currently available to nonprofit organizations.

The Funding/Performance Disconnection

An often-heard and wholly justified complaint in the nonprofit sector is that "funding is not tied to performance." Even when they accomplish their objectives and demonstrably increase their impact, NPOs encounter great difficulty in raising the funds they need to grow. It is a frustrating and debilitating experience for all concerned that burns out its most talented practitioners and causes unacceptably high levels of turnover that sap the strength of the sector. Consider how one exasperated leader recently vented his frustration:

> Another challenge of performance measurement has been how little it is valued or used by the funding community in the nonprofit sector. The connection between Jumpstart's success at demonstrating impact and its ability to fund raise is at best tenuous. Fund raising success comes primarily from building relationships based on trust and reputation—which can be completely disconnected from the actual performance of the organization. Furthermore, continued funding from philanthropic sources, other than venture philanthropists, is not contingent on achieving specific performance milestones. I've grown incredibly frustrated by the total disconnect between performance and access to capital in the nonprofit world. We double every single year, we get better impact measurements, and still no one ever comes back to us and says, "Hey, you guys are doing so great, we want to give more. We want to invest more."[42]

Nonprofit performance doesn't have clear financial consequences, whether in the form of incentives or penalties. Harvard professor Allen Grossman has contended that philanthropy "actually discourages management from pursuing performance as a primary objective":

> The conversation must begin with an analysis of how and why the philanthropic capital markets, for the most part, fail to encourage high performance in nonprofit organizations. Ironically, nonprofit executive directors, in numerous interviews, consistently reported that excellent performance of a nonprofit organization is rarely systematically rewarded with an increased flow of philanthropic capital. In fact, an opposite situation prevails. As programs were proven effective and the nonprofit organizations developed plans to grow, foundations (even those currently funding their organizations) were less receptive to their requests for funding. Nor is there a systematic reduction of philanthropic funds for mediocre performance. Examples abound of low performing nonprofit organizations that are kept afloat by sympathetic donors willing to contribute without objective data.[43]

The efforts to identify and reward high-performing nonprofits have been numerous, diverse, and, broadly speaking, unsuccessful.

Tremendous strides have been made in recent years in strategic planning, goal-setting, disciplined management, and performance measurement within not only individual NPOs, but also the entire investment portfolios of enlightened funders committed to accountability and performance enhancement. However, the nonprofit sector as a whole still is not structured in ways that connects dollars to impact. As one discouraged executive director put it,

> Everyone says they want to be data-driven in their decision-making. But now we have all of this robust data, and it doesn't seem to have any effect on funders' decisions. . . . From the viewpoint of financial sustainability, we are no better off than before.[44]

The chief operating officer of the Better Business Bureau's Wise Giving Alliance confirms that "the unfortunate fact is the public doesn't in general do research. People base their decision on the appeals they receive, and they respond accordingly."[45]

There are many explanations for this generally accepted reality, having to do with myriad factors such as the complex missions of social organizations, their historical roots in volunteerism and charity, and the limited resources available to them for enhancing organizational capacity. And if performance and funding were connected, poor performance would have consequences: "Ineffective nonprofits would come under attack, and some of them would shrink . . . and some of them would cease to exist. Stale old models would change, or they would die."[46]

All of these considerations bear on the issue in significant ways, and the mismatch between impact and funding is not amenable to easy solutions. If it were, any number of intelligent and dedicated nonprofit professionals would have figured it out by now.

Small Caps and Large Caps

As we look more closely, though, we can see that the problem is not homogeneous. Across much of the nonprofit world, the disconnection between funding and impact doesn't matter all that much. The vast majority of the more than 2 million NPOs in the United States are quite small volunteer and community-based organizations that do good and noble work locally with budgets substantially below seven or even six figures. Let's call them the "small caps," referring, of course, to their financial capitalization.

This is a vast and diverse constellation of small stars that enriches American life and does much to ameliorate the cultural and social deprivations that fall haphazardly upon the unlucky. From local food pantries to arts councils and blood drives, from sports leagues to literacy programs and voter registration drives, there are hundreds of thousands of voluntary groups and associations that emerge spontaneously from the goodness of people's hearts and make small but important differences in millions of lives. Significant growth is not an important objective of such organizations, so the fundraising burden is a tiresome but accepted fact of life.

At the other end of the spectrum—the "large caps"—we find the brand-name behemoths of the social sector: the Red Cross, the United Ways, the Boys and Girls Clubs, and the universities, hospitals, and leading cultural institutions found in every large metropolis. An entirely different calculus drives the funding of these mainstream organizations, starting with the fact that most of them were founded with substantial endowments.

But large-cap nonprofit organizations also mount massive and coordinated capital campaigns raising tens or hundreds of millions of dollars that are managed by financial professionals as expert as any found on Wall Street. They rely on six-, seven-, eight-, and even nine-figure bequests, institutional constituencies, social elites, and celebrity supporters. In this rarified atmosphere, growth is a paramount driving force, but the large caps have perfected the art and science of Olympian fundraising.

These mighty NPOs do not suffer from any supposed mismatch between performance and funding. Yes, fundraising is an insatiable beast that must be fed constantly, but there is no shortage of nourishment. Yes, it takes enormous amounts of time, effort, and money to meet ever-increasing fundraising targets, but the large caps have the wherewithal to exceed their goals year after year. In 2006, for example, the United Ways raised a staggering *$4.14 billion*.[47] Whatever fundraising challenges the large caps face, the lack of a system for rewarding performance is not part of the problem.

Mid-Caps and $100 Million Problems

Between these two extremes, however, there is an important and sizable segment of NPOs for which the absence of a reasonably direct and reliable connection between performance and funding is surpassingly important. I've been talking about the "large caps" and the "small caps" in terms of their total revenues, but there's another important dimension that distinguishes the "mid-caps."

Many of our most innovative mid-caps work on our most serious and widespread social problems, the kinds that consign millions of people to life in a largely permanent and stubbornly inescapable underclass. As I discuss in Chapter 2, the members of the underclass often remain stuck there from one generation to the next, and almost always for extended periods of time measured in years and even decades. Leading social entrepreneurs concern themselves with problems endemic to the underclass that are similar in scope, complexity, and consequence to matters handled by federal, state, and local government agencies, such as education, employment, health care, public safety, and housing.

Two renowned pioneers of the nonprofit world, Mario Marino of Venture Philanthropy Partners and Bill Shore of Community Wealth Ventures, have observed a similar trichotomy of small-, mid- and large-cap organizations:

> At the outset we should clarify to which part of the nonprofit world our observations apply. The nonprofit sector is composed of large and complex institutions like health care systems, universities, art museums, and cultural organizations, as well as tens of thousands of small, local human service providers that perform with compassion, effectiveness, and efficiency. Many of the former have characteristics that enable them to achieve both scale and sustainability. Many of the latter are volunteer-based with appropriately no agenda or ambition beyond their neighborhood and the immediate tasks before them, nor should they. The strategies of highly engaged philanthropy might not be relevant or useful to either broad category. But they may be relevant to a specific subsector of nonprofit community-based organizations that—by virtue of size, ambition, need, resources, geography, and experience—do break through to another level and find themselves facing challenges associated with scale and sustainability, as well as for

> aspiring social innovators working to affect large, and in many cases, public systems. Certainly the challenge of the inadequacy of both operating and growth capital, which we discuss, faces the whole sector and not just those organizations dealing with the delivery of social services. However, most of the high-engagement strategies appear to be more applicable to the specific subsector mentioned above.[48]

By "transformative social impact," I mean substantially and permanently reducing structural barriers to educational and economic opportunity to enable poor and low-income people to become self-sufficient. In their very fine book, *Philanthrocapitalism: How the Rich Can Save the World*, Matthew Bishop and Michael Green offer an apt illustration of a British charity, the Children's Investment Fund Foundation:

> After CIFF exits a project, says [founder] Jamie Cooper-Hahn, the children it has worked with should be healthy and have the ability to protect themselves and their families from disease. They should be equipped to provide for themselves and their families' nutrition, education, and health.[49]

Another example (this time from a small cap) is the work of Ron Rivera, who died in 2008 after completing his thirtieth "factory"—really, a small rural business—for the production of special clay-pot water filters that make contaminated water safe to drink. Rivera wanted to "put a dent" in the tragedy of 5 million people dying each year from drinking unclean water.[50] Surely he succeeded, having built the capacity to produce potable water for approximately 1.5 million desperate people in Colombia, Honduras, El Salvador, Mexico, Burma, Bangladesh, Nigeria, Kenya, Cambodia, Cuba, the Dominican Republic, Darfur, Ghana, and Sri Lanka.

At the national level, the United Way has set transformational goals to be achieved by 2018: "cut by half the number of young people who drop out of high school, cut by half the number of lower-income families that lack financial stability, increase by a third the number of youths and adults who are healthy and avoid risky behaviors."[51]

The achievement of lasting and decisive social changes will require nonprofits to conduct much bigger field experiments than they normally undertake. NPOs will have to align themselves, both vertically and horizontally, with complementary organizations, as well as with business and governmental organizations, to see if they can deliver results on a much larger playing field with many more clients. Doing this will require significantly larger and more capable staffs, management teams, support systems, and infrastructure, all of which will require substantially more money and organizational horsepower than mid-caps handle today.

How much will it cost to demonstrate the potential to achieve transformative social impact? Many successful mid-caps have annual budgets of \$10 million to \$20 million, which they're using to reach levels of growth that, although large on a relative scale, fall well short of national or even regional impact. For purposes of our discussion, I think we need to consider what levels of funding would be needed to serve at least 5 to 10% of the total population in need, rather than the less than 1 to 2% that even excellent social enterprises are reaching today. Until such organizations can increase their impact by five or ten times, I don't think we can say that we're on the path to transformative impact. That translates into annual budgets in the very pricey neighborhood of \$100 million or so.

Keep in mind that I'm referring to large-scale, integrated programs that can demonstrate success at the level of a state or a large urban or metropolitan area. I anticipate that several complementary mid-caps would have to coordinate their efforts for such an ambitious undertaking, so that "\$100 million" would represent a very round number of the total cost of their combined effort to mount large-scale pilot projects that could make a convincing case for potential systemic change.

For example, the Edna McConnell Clark Foundation organized a \$120 million "Growth Capital Aggregation Pilot" with 19 foundations, corporations, and individuals after "funding experiences over the past seven years convinced the Foundation that its most successful grantees required more support than EMCF alone could provide if they were to help solve at sufficient scale some of the nation's most intractable social problems."[52] Funders Together to End Homelessness was formed to "generate the philanthropic commitment necessary to transform political will and policies, by leveraging at least \$100 million in funding from other national and locally-based foundations, financial institutions and businesses."[53] The MacArthur Foundation, recognizing that "only broad, concerted strategies will bring lasting solutions," started a $100 million "Models for Change" initiative that hopes to reduce juvenile incarcerations by "screening young offenders for mental health problems, identifying those who have been involved with child welfare services, and providing earlier intervention by schools [to] divert a large proportion to community services."[54] Clara Miller believes that growth-capital grants intended to scale organizations should be "typically in the tens of millions of dollars."[55]

Now, $100 million is a lot of money, but it's not as stratospheric as you might think. TFA is trying to build an annual funding base of that size by 2010. As of 2007, the total amount of grants to organizations working on global warming was nearly $100 million,[56] and the Doris Duke Charitable Foundation recently committed that amount for climate change research over five years.[57] The Ford Foundation is contributing $100 million to 18 organizations in 13 countries working on local poverty solutions,[58] and the Gates Foundation made an initial investment of $100 million in the Alliance for a Green Revolution in Africa. The Omidyar Network has started a $100 million microfinance fund with Tufts University, although they've "discovered that a hundred million dollars might be difficult to place."[59]

In the private sector, $100 million will buy Kleiner Perkins's "iFund" investment in iPhone-related start-ups;[60] IBM's annual investment in campus computing;[61] a house, if you're the founder of Microsoft or Oracle Corporation;[62] a six-year contract to play baseball, if you're Houston Astros' left fielder Carlos Lee;[63] Ivan Boesky's insider trading fine;[64] gifts to Stanford and Brown universities, if you're real estate developer John Arrillaga[65] or convenience store owner Warren Alpert;[66] or former New York Stock Exchange chairman Richard Grasso's legal bills (as of early 2007) to defend himself (successfully, as it turned out) from an excessive compensation suit by the state attorney general.[67]

So I'll use the term "$100 million problems" as shorthand for this new and considerably more ambitious level of effort, complexity, and scale. Of course, full-scale implementation for any nationwide effort will cost billions of dollars, but I hope "$100 million problem" is a useful way to illustrate the steepness of the climb that must be made to achieve the next stage of American social progress. The renowned thought leaders at REDF might agree:

> [W]hen funders seek to solve a long-term problem, Strategic Co-Funding is called for. A group of funders aiming to improve the economic health of Latino communities, for example, would need to take a Strategic Co-Funding approach. The result might be a $100 million, 10-year plan for revitalizing 10 communities.[68]

I can understand why some people might balk at "throwing" such large sums of money "at" social problems that have long resisted well-intentioned efforts at reform. But we should learn from past failures, not submit to them. Nor should we lose heart when there is so much to be gained.

Consider the example of hunger in the United States. Some 35 million Americans live in families that don't have enough to eat. According to a study commissioned by the Sodexho Foundation and conducted by researchers at Harvard, Brandeis, and Loyola universities, the total "economic burden" of hunger, including charitable contributions, impaired educational outcomes, and related physical and mental illnesses, is more than $90 billion annually. But the estimated cost to strengthen existing federal nutrition programs to virtually eliminate hunger would be about $10 to $12 billion.[69]

Of course, the $90 billion annual expenditure is an estimate derived from myriad direct and indirect costs that are so diffused as to be virtually nonexistent, while a $12 billion increase in federal outlays would (and should) be the subject of sharp debate among nearly innumerable contending stakeholders. Moreover, as the authors concede, "[T]here is more to ending hunger than providing food for those in need." Ample experience has proved there isn't a linear relationship between public expenditures and the diminution of social problems. But the extent of the apparent overspending relating to inadequate nutrition and its consequences, combined with the unrealized potential from such underfunded innovations as the National Anti-Hunger Organizations' "Blueprint to End Hunger" should embolden philanthropists and policy-makers alike to consider more sophisticated approaches to funding.[70]

Nurse-Family Partnership provides a singular example of the potential power of growth capital. Founded more than 30 years ago, NFP is "an evidence-based, nurse home visiting program that improves the health, well-being and self-sufficiency of low-income, first-time parents and their children."[71] Extensive independent studies confirm that NFP reliably produces improved prenatal health; fewer childhood injuries; fewer subsequent pregnancies; increased intervals between births; increased maternal employment; and improved school readiness for children born to mothers with low psychological resources. Financial performance is equally impressive: every dollar NFP spends on higher-risk families saves $5.70 in government expenditures and other social costs; every dollar NFP spends on the average participating family saves taxpayers $2.88.

EMCF chose NFP as one of the first three grantees (along with Youth Villages and Citizen Schools) of its Growth Capital Aggregation Pilot in order to:

> Demonstrate that a large infusion of philanthropic capital, committed in full before the implementation of a sound business plan, can propel the growth of a nonprofit organization with evidence-based programs and leverage the additional, more reliable funding, public as well as private, that can sustain the organization at its new, greater scale.

In the case of NFP, EMCF set out to tackle the same market penetration problem discussed earlier:

> Clearly, NFP had developed a program with impressive, proven outcomes for the 12,700 poor, first-time families it served in 2007. But 650,000 such families are formed in the United States every year. How could EMCF help NFP achieve the scale that would make a significant national impact? NFP's business plan set a goal of expanding enrollment to 100,000 families annually by 2017, yielding a social return of over $5.4 billion. Implementing the plan would require an initial investment of $50 million in growth capital.

Under the NFP plan, the percentage of families served would increase from 2% in 2007 to 15% in 2017, a nearly eightfold increase. The $5.4 billion value of the social return produced would represent a 1,080% return on the $50 million co-invested by the Bill and Melinda Gates Foundation, the Robert Wood Johnson Foundation, the Kresge Foundation, the Picower Foundation, and NFP's board of directors.

But EMCF is the exception that proves the rule. Simply put, "[T]he [foundation] field has not developed an approach that supports long-term solutions to the long-term problems it seeks to address."[72] Hence our collective dilemma: foundations provide only about 12% of all charitable giving, but they could—but generally don't—leverage their resources by co-investing. Individuals contribute more than 75% of all donations, but they aggressively defragment their funding, precisely the opposite of strategic investing.

The point is this: for mid-cap nonprofits with "one day, all children" visions that want to solve $100 million problems, exponential growth is vital. The gulf between performance and funding is one of the most profound and frustrating obstacles they face, and the narrowing of that gulf requires consideration of entirely new approaches to financing growth that is five or ten times higher than today.

Making the Most of a New "Golden Age"

It has become something of a cliché—albeit a well-founded one—that we are now in a "golden age of philanthropy"[73] in terms of the unprecedented amount of money gushing into the nonprofit sector. The bursting of the Internet bubble appears to have been just a temporary setback for the American economy, and the upper ranks of wealth continue to swell in both numbers and size of fortunes. (As of this writing, it is too soon to say whether and for how long "the Great Recession" of 2008 might reverse or slow these trends.) Philanthropy has increased as a direct result, well beyond the media fascination with the likes of Bill Gates, Warren Buffett, and Oprah Winfrey. The U.S. nonprofit sector now collects more than $300 billion each year.[74] In $100 bills, that would be a stack more than 200 miles high.

But the unprecedented growth in both the aggregate amount of donations and the burgeoning number of NPOs clamoring for their share—*2 million*—has only attenuated further the relationship between funding and performance. Paradoxically, the fact that the social sector as a whole is not short of money makes the disconnection between funding and performance more acute for mid-cap NPOs.

By itself, the unprecedented increase in the total amount of dollars donated to charitable causes would not require the creation of new capital market structures. Rather, the need for more effective capital allocation systems arises from the confluence of increased funding with three other important trends:

- High-engagement philanthropy
- More capable social entrepreneurs
- The foreclosure of the American Dream for millions of families

High-Engagement Philanthropy

Mario Marino of Venture Philanthropy Partners and Bill Shore of Community Wealth Ventures coined the phrase "high-engagement philanthropy" to describe "an approach in which the funders or 'investors' are directly and personally engaged and involved with their investment partners (in traditional terms, the grantees) beyond providing financial support." Important nonfinancial support can include such value-added strategic activities as "long-term planning, board and executive recruitment, coaching, help in raising capital, assuming board roles, accessing networks, and leveraging relationships to identify additional resources and facilitate partnerships."[75] Katherine Fulton and Andrew Blau of the Monitor Group have neatly summarized just how much high-engagement philanthropy differs from traditional models (see Exhibit 1.6).

In the financial sector, it's not just the money that venture capitalists, investment banks, and other intermediaries provide to fledgling businesses that helps the economy to flourish and the stock markets to set new records (2008–2009 reversals notwithstanding). It's also the expertise that comes into play when significantly larger tranches of money are made available for investment with potentially high payoffs. In fact, major investors have a lot to say about how the money will be used and who will be hired in senior posts to help their companies grow.

In the nonprofit sector, the funding architecture is quite different. Typically, it starts with rather informal "first-stage" donations in the hundreds and thousands of dollars from friends, family, and local community groups, and then progresses to more formal "second-stage" funding of five- and six-figure grants by foundations, institutions, and venture philanthropies.

Exhibit 1.6 What Are the Patterns in the Innovation?

Old Patterns or Habits	**Seeds of Change**
Giving primarily late in life	Giving throughout life
Foundation as the key institutional form	Foundations as one form among many
Social benefit equals the nonprofit sector	Social benefit can come from any sector
Philanthropy corrects for the market, because the market is part of the problem	Philanthropy connects to the market, because the market is part of the solution
Older, white, male leadership	Diversifying leadership
Donors focus on the communities where they live or have a connection	Donors focus both close to home and on systemic global problems with equal ease
Donors set general goals	Donors set specific targets
Donors make gifts	Donors make investments, award contracts, and gifts
Money is the resource, grants the tool	Influence is the resource, money is one tool
Donors keep grantees at arm's length	Donors highly engaged with partners
Donors give independently	Donors give independently and give together
Donors content to do good	Donors try to assess impact
Donors learn from their own work	Donors learn from their work and share what they learn with others

Source: Katherine Fulton and Andrew Blau, "Looking Out for the Future: An Orientation for Twenty-First Century Philanthropists," Monitor Institute, 2005. Future of Philanthropy, Monitor Company Group, LLP, 3 Aug. 2007, www.futureofphilanthropy.org/files/finalreport.pdf.

After the second-stage funding, the nonprofit capital market runs out of steam, at least for mid-caps. There is almost no "third-stage funding" of capital in the form of (1) long-term six- and seven-figure grants pooled from multiple sources; (2) coordinated to support integrated projects;

(3) to be undertaken by one or more successful mid-cap NPOs; (4) for the purpose of attacking $100 million problems.

So high-engagement philanthropy holds considerable promise for third-stage funding to address $100 million problems, but its realization requires something more. A three-tiered financing system makes sense for mid-caps in the nonprofit sector. I will attempt to describe what such a system might look like and how its development can be fostered.

More Capable Social Entrepreneurs

One of the defining characteristics of the new wave of innovative nonprofit organizations is the strategic and multidisciplinary approaches they take. The causes of social and economic disadvantage are many and varied, so disadvantaged children and adults have quite a variety of needs, many of which don't fall within the narrow boundaries of traditional NPOs.

For example, educational entrepreneurs define their domains of responsibility with unprecedented breadth: stability in the home, parental involvement, homework completion, academic remediation, safety at home and in school, transportation, truancy and tardiness, and even sound nutrition. Great "out-of-school-time" programs like the Breakthrough Collaborative, Citizen Schools, and BELL (Building Educated Leaders for Life) have figured out what's preventing their students from succeeding in school and they fill as many of those gaps as they can.

Charter and other innovative public schools like Knowledge Is Power Program (KIPP) and Green Dot teach their students about such essential but generally overlooked skills as punctuality, attentiveness, public speaking, expectations-setting, long-term thinking, and planning for college. Consider the impressive outcomes for KIPP students:

> In the 2005–2006 school year, more than half (59 percent) of KIPP fifth grade classes outperformed their local districts in reading/English language arts at the end of their first year in KIPP schools, as measured by state exams. Nearly three-fourths (74 percent) of KIPP fifth grade classes outperformed their districts in mathematics. In the 2005–2006 school year, 100 percent of KIPP eighth grade classes outperformed their district averages in both mathematics and reading/English language arts, as measured by state exams.[76]

Even some traditional large caps are taking a page from the social entrepreneurs' playbook and have begun exploring more strategic and disciplined approaches. For example, in May 2007, the United Way of Massachusetts Bay and Merrimack Valley announced a new funding strategy that abandoned the old "something for everyone" approach (my term, not theirs) to focus on four strategic areas: healthy child development; youth opportunity; family-sustaining employment; and safe and affordable housing:

> With this change, United Way is pioneering an approach that combines the flexibility of providing unrestricted operating support to agencies with the accountability of expecting them to achieve specific contributions to measurable community goals.[77]

Social entrepreneurs and venture philanthropies have not only broadened the vision of what kinds of primary and secondary services people need to overcome structural barriers to self-sufficiency. They are also redefining the capabilities and resources organizations must have to deliver them broadly and effectively. Such thinking has worked before. One example is the reduction in youth violence attributed to the "Boston Miracle" of the 1990s:

> The Boston Miracle was about more than just law enforcement and lengthy imprisonment. It was a balanced approach to crime: a strong and genuine partnership among law enforcement agencies, the active support and involvement of the communities most victimized, and the availability of meaningful alternatives to those youth tempted to commit crimes. It understood the important role of the schools, the social service departments, businesses, and the community in addressing long-ignored problems.[78]

Foreclosing on the American Dream

I will address this issue at some length in Chapter 2, "The American Underclass," but let me preview three themes of that discussion:

1. The $100 million problems that I believe necessitate new capital-driving institutions share certain common characteristics: they are

massive and pervasive; they seem intractable; and they are incapacitating. By *incapacitating*, I mean they impede access to the tools for achieving basic economic opportunity (such as an effective education) that those of us who are more privileged consider an American birthright. All $100 million problems share these challenging attributes.

2. The combination of these factors makes the indefinite continuation of these $100 million problems simply untenable not only for the people who face them directly, but for the economic mainstream as well. We cannot allow the United States to have a permanent underclass that numbers in the tens of millions. It is not merely unjust, but a real danger to our domestic tranquility and global competitiveness.
3. These problems no longer lend themselves to purely governmental, or even government-centric, solutions. Systemic change and transformative social impact will not be possible without significantly more purposeful, effective, and sustained involvement by the nonprofit sector.

In the United States today, there are tens of millions of people in this country to whom the American Dream is simply not available. They cannot fend for themselves because the problems they face are too big and too impervious to existing government responses, and they lack the most basic resources needed to achieve self-sufficiency.

Our inability to put this unacceptable state of affairs right results not from the amount of money available for NPOs but rather from its distribution and deployment:

> Nonprofit enterprises suffer not so much from a lack of money (though reliable revenue is scarce in some subsectors and unevenly distributed throughout), but from a lack of something more fundamental—equity capital, as well as a lack of the managers, board members, and philanthropic investors who know what nonprofit equity capital is and how to deploy it successfully.[79]

Charitable donations find their way to grantees through a haphazard combination of luck, charisma, and razzmatazz that is poorly suited to the importance of their work. Consideration of which organizations can use the money most effectively plays only a small part, in large measure because there are so few cause-and-effect signals to which donors can respond.

When tens of billions of dollars can't find their way to their best uses, there is a massive but unquantifiable opportunity cost to society. The misallocation of funding represents not just "inefficiency" or even "waste" as those terms are commonly used, but a loss of potential impact of enormous proportions. Even if every penny donated was used efficiently, there would still be massive underutilization of the available resources.

There are two related forms of such opportunity costs. First, by failing to direct donations to the most effective NPOs, society suffers a corresponding loss of beneficial impact. Second, the diversion of staff energy to relentless fundraising is a crippling distraction that the sector cannot afford.

Of Drops and Buckets

WARNING! EXTENDED METAPHOR ALERT!

If the impact of social entrepreneurs is but a drop in the bucket of national need, then fundraising today is like an unending series of downpours in which there are hundreds of billions of raindrops—donated dollars—falling into nearly 2 million nonprofit buckets. At any given time, some buckets are overflowing, some are empty, and most have some rain.

The allocation of rain into buckets isn't exactly random, but it's not entirely logical, either. That is, there's some correlation between the amount of rain that falls into particular buckets and the amount those buckets "need," but the fit between the demand for and the supply of rain is surely not the "best" one we could envision if we had better ways to gather reliable information about the weather and to use that information to allocate water more effectively.

Part of the problem is we don't know what the optimal distribution of water is, either in the aggregate or among individual buckets. In fact, we don't really know what the actual distribution is, that is, how many buckets have how much water in them (although I suppose we could examine each of more than a million buckets to find out, if we had all the time in the world, which we don't).

There's no mechanism like a common system of pipes or funnels to direct the "right" amount of rain into the "right" buckets. Rather, our metaphorical system depends on more than a million people holding more than a million buckets running around trying to catch hundreds of billions of raindrops. After the storm ends and the carriers use whatever water they've collected, they take their buckets out in search of new storms and the process of chasing raindrops begins anew. This goes on essentially forever. They cope with this problem by using larger and larger buckets and hiring more and more people to run around holding them up during storms.

This is an incredibly chaotic scene we're imagining. There are more than 100 million clouds, but it's hard to tell which ones are going to rain, when, or how much. Everyone is looking up, studying the same clouds while they're running around holding up their buckets and banging into each other, and shouting up to the clouds that look like they're going to rain, "Over here! Over here!" At the same time, the clouds are looking down at all this bedlam, trying to figure out which buckets need rain the most and which ones will make the best use of whatever water they collect.

When the storm passes and everyone looks in their buckets, some are full and the carriers are more or less content because they own many such full buckets and they really need and will make very good use (or at least pretty good use) of quite a lot of water. Many other small buckets contain just a little rain and the owners are more or less content because they don't actually need that much water and they will do the best they can with whatever they get.

But a lot of buckets will have less water than the owners need, and certainly less than they could put to good use. Those

(*Continued*)

owners are chronically dissatisfied with the amount of rain they get, but they doggedly persevere, constantly on the lookout for more storms. They race out whenever dark clouds appear, at least until they're so exhausted that they look for another line of work.

To improve this dismal situation, we first need to acknowledge that this "system" doesn't work for bucket holders that are neither large nor small. Those in the middle are using water for our most important social needs, such as responding to massive droughts and growing crops to feed millions of hungry people. The grim reality is that they're never going to get enough water by running around holding up buckets to catch a few drops from thousands of small storms.

Second, we need to separate the job of water-using from the job of water-gathering. Water-using is a highly challenging, full-time job that requires a certain set of skills; water-gathering is a quite different enterprise involving a quite different set of skills. When water users are forced to gather water, too, the water isn't used as productively as it otherwise could be.

If we could make the clouds smarter about where, when, and how much they rained, the water users could devote more attention to making better use of greater amounts of water. We would need to collect better information about water needs and water usage so the clouds could make better decisions about which buckets they want to fill. The result should be to make the overall distribution of rain more beneficial than it is now.

ALL CLEAR! THE METAPHOR HAS PASSED!

A Potential Inflection Point

The primitive state of the nonprofit capital market imposes an upper limit to the achievement of social progress that is substantially below what the sector is otherwise capable of achieving. We have the means and know-how to accomplish much more than we do, but the financial system does not and, indeed, cannot make the required funds available to the organizations that could best put them to productive use. For certain kinds of social problems—$100 million problems—and certain kinds of nonprofit organizations—mid-cap social enterprises—traditional methods of fundraising simply don't work. They take too much time or attract too little money, or, most often, both, and they don't connect funding to performance.

Without a much more sophisticated and intelligent capital-generation and -distribution system, successful nonprofit organizations can achieve "scale," that is, they can grow larger relative to their current baselines, but they cannot achieve "transformative social impact," that is, they cannot solve our most damaging social problems to an extent that is significant relative to the total need. Established fundraising practices will no doubt be with us for the indefinite future and they will always represent a vital part of the mix across the entire funding spectrum. If we aspire to achieve essential social progress, such as conquering educational inequity and extending economic opportunity, then we must develop new methods and institutions that are up to the task of raising much larger sums of money with much less effort, time, and cost, and distributing it in ways that increase its impact.

We now face a potential inflection point at which the nonprofit sector (working in partnership with business and government) can dramatically improve its effectiveness and make substantial headway against what have seemed like intractable problems of the first order. But we cannot take advantage of this opportunity until nonprofit professionals recognize that the financial tools available today are structurally incapable of supporting the required level and complexity of effort.

Bringing more horsepower to nonprofit capital markets will force sector leaders to face uncomfortable choices, and consider innovative approaches that will be unfamiliar. But if we agree that the time has come to achieve transformational social impacts that will actually enable large segments of the underclass to achieve self-sufficiency, we must begin by acknowledging that existing funding models won't take us there.

Just as experienced financial investors find the most lucrative investment opportunities before everyone else, we need to help "smart money" find the most capable nonprofits that are ready to take on $100 million problems. If we really want to help "all children" but we don't want to wait forever for "one day" to arrive, we need to turn the fundraising paradigm on its head:

> We need a financing system that helps highly engaged social impact investors to direct third-stage growth capital to the best mid-cap nonprofits, instead of one that forces those nonprofits to spend all their time looking for more drops to fill more buckets.

Objectives of This Book

So this book has two objectives. The first is to explain why meaningful reductions in poverty, illiteracy, violence, and hopelessness will require a fundamental restructuring of nonprofit capital markets. Such a restructuring would need to make it much easier for philanthropists of all stripes—large and small, public and private, institutional and individual—to fund nonprofit organizations that maximize social impact. It would also need to make it possible for promising mid-caps to raise much larger pools of money with substantially less time and effort.

There are encouraging signs that such a restructuring is already taking shape. NFF Capital Partners acts as a "benevolent broker" to facilitate nonprofit "capital campaigns of $5 million or greater."[80] SeaChange Capital Partners will help nonprofits with revenues in the range of $2 million to $75 million revenue "with a multimillion dollar round of financing, sized to fund a well-defined, multiyear growth plan."[81] The Edna McConnell Clark Foundation has raised $120 million for its Growth Capital Aggregation Pilot.[82]

These are singularly important experiments advanced by some of the most sophisticated financial minds the nonprofit sector has to offer. Of necessity, however, these are carefully vetted offerings for a small number of exceptional organizations. They are not designed to be broad-based innovations, nor should they be. I hope to persuade readers that this nascent development must be extended and increased by orders of magnitude if we hope to rescue the American Dream for millions of families.

Second—and this is where I'm going to have to ask you to hear me out—I make the case for a new nonprofit capital market institution, a virtual stock market, as one way to help highly engaged social investors find promising NPOs where their money can do the most good. The virtual stock market, which I call "the Impact Index," or "IMPEX" for short, would take the form of a "prediction market" designed to harness what *New Yorker* financial columnist James Surowiecki most famously called "The Wisdom of Crowds." We will explore this at some length, but for now I will just note that Surowiecki grounds his thesis in what he rightly calls a "mathematical truism":

> If you ask a large enough group of diverse, independent people to make a prediction or estimate a probability, and then average those estimates, the errors each of them makes in coming up with an answer will cancel themselves out. Each person's guess, you might say, has two components: information and error. Subtract the error, and you're left with the information.[83]

A Virtual Nonprofit Stock Market

The idea of the nonprofit virtual stock market would be to emulate market-like signals to help "smart money" find its "best" uses—however investors define "best" for themselves—with the intended side-effect of significantly reducing the cost and effort of raising funds to support both programs and organizations.

Like other free market mechanisms, the IMPEX would be "designed to solve [the] coordination problem [of] getting resources to the right places at the right cost."[84] It would increase "signals" and reduce "noise" about nonprofit performance by coalescing the views of thousands of people who follow their work into a more coherent picture.

The idea of a nonprofit virtual stock market has been mentioned by a few thought leaders, but it has not received sufficiently careful or comprehensive consideration. It would be modeled after the kinds of prediction markets (also called *information markets*) that have been used to forecast the outcomes of such diverse events as political elections, economic policy decisions, athletic competitions, box office receipts, book sales, and new product launches. Extensive academic research has confirmed the predictive accuracy of such markets when they are well designed. Indeed, a new industry is emerging to bring prediction markets inside corporations to help them make more informed decisions about such matters as what strategic direction the company should take or which new product should receive more marketing support.

The mechanism that enables these virtual markets to operate is a simple voting system that allows a sizable and diverse group of reasonably knowledgeable participants to conduct virtual "trades" when they believe that other participants are underestimating or overestimating the chances that a certain future event will occur. The market should produce a rough consensus of the true probabilities and provide an inexact but still informative ranking of the events in terms of their relative probabilities.

In the case of the nonprofit sector, prediction markets might help investors identify which approaches to, say, improving high school graduation rates or educating teens about pregnancy prevention are likely to be the most effective, as a way of informing their philanthropic choices. Such markets might also help discover overlooked organizations that deserve wider consideration, just as the stock market helped tip the balance in favor of eBay rather than its many long-gone competitors in what was then the new field of online auctions.

I hope to provide the first in-depth consideration of a nonprofit virtual stock market here, by answering three questions:

1. Why does the nonprofit sector need a capital market to achieve transformational social impact?
2. What would a nonprofit virtual stock market look like, and what would it do?
3. How could a nonprofit stock market be developed to help link funding and impact in the near term?

I will suggest both "laboratory" and field experiments to test whether an Impact Index could be developed that would provide some measure of rank-ordering of NPOs according to their perceived effectiveness.

Throughout the discussion, it will be extremely important to understand clearly what an Impact Index would and would not do, how it would differ from financial stock markets, and what its potential value and limitations might be. As an opening cautionary note, I do not contend that philanthropists would "own" nonprofit shares, that social investors would earn financial returns on their donations, that the Impact Index would be the sole or even primary source for making decisions about giving money to NPOs, or that the Impact Index would establish how much NPOs, either singly or collectively, are "worth." IMPEX rankings would be one source of information—guidance, not algorithms—that individual investors could incorporate into their decision making to whatever extent they think wise.

Nor do I delude myself into thinking that the IMPEX would magically transform the chaotic nonprofit funding circus into an exact science that would perfectly match nonprofit performance and funding. My aspirations are considerably more modest but, I hope, realistic. Given the primitive state of the nonprofit capital market as its exists today and the mystifying fundraising system under which mid-cap nonprofits labor, a tool that might improve the signal-to-noise ratio for nonprofit effectiveness could help channel funds in more intelligent ways that would enable the social sector to break through the unacceptably low ceiling of impact.

Notes

1. Wendy Kopp, *One Day, All Children* (New York: Public Affairs, 2001).
2. Teach For America, "Our Nation's Greatest Injustice," 12 Sept. 2007, www.teachforamerica.org/mission/index.htm.
3. Douglas N. Harris, "Background," in "Ending the Blame Game on Educational Inequity: A Study of 'High Flying' Schools and NCLB," March 2006, Education Policy Studies Laboratory, Division of Educational Leadership and Policy Studies, College of Education, Arizona State University, www.asu.edu/educ/epsl/EPRU/documents/EPSL-0603-120-EPRU.pdf.
4. Ibid.
5. Bob Herbert, "A Dubious Milestone," *New York Times*, 21 June 2008, www.nytimes.com/2008/06/21/opinion/21herbert.html?hp.
6. Kane, Parsons & Associates, "Studies on Corps Member Impact: What the Research Says," Teach For America, 18 Sept. 2007, www.teachforamerica.org/mission/our_impact/studies_corps_impact.htm.
7. www.teachforamerica.org/mission/our_impact/corps_impact.htm.
8. Zeyu Xu, Jane Hannaway, and Colin Taylor, "Making a Difference? The Effect of Teach for America on Student Performance in High School," Urban Institute, 27 Mar. 2008, www.urban.org/url.cfm?ID=411642.

9. www.teachforamerica.org/about/our_growth_plan.htm.
10. Patricia Sellers, "Schooling Corporate Giants on Recruiting," *Fortune*, 27 Nov. 2006 and 17 Sept. 2007, http://money.cnn.com/magazines/fortune/fortune_archive/2006/11/27/8394324/index.htm.
11. Wendy Kopp, interview with Stephen Colbert, *The Colbert Report*, Comedy Central, 17 Sept. 2007, www.colbertnation.com/the-colbert-report-videos/81750/february-05-2007/wendy-kopp.
12. "Our Work," NewSchools Venture Fund, http://newschools.org/work.
13. "Charter Management Organizations," NewSchools Venture Fund, 14 Apr. 2008, www.newschools.org/portfolio/impact/charter-management-organizations.
14. Shirley Sagawa, "Fulfilling the Promise: Social Entrepreneurs and Action Tanking in a New Era of Entrepreneurship," pre-reading materials, Gathering of Leaders, 15–17 Feb. 2006, New Profit, Inc., Ed. Shirley Sagawa and Deb Jospin, 4 Oct. 2007, www.sagawajospin.com/Fulfilling%20the%20Promise_Sagawa_February%202006.pdf.
15. Robert S. Kaplan, "New Profit Inc.: Governing the Nonprofit Enterprise," Harvard Business School, Case Study 9-100-052, p. 1 (rev. July 3, 2001).
16. Michael E. Porter and Mark R. Kramer, "Philanthropy's New Agenda: Creating Value," *Harvard Business Review* (Nov.–Dec. 1999): 127, harvardbusinessonline.hbsp.harvard.edu/b01/en/common/item_detail.jhtml?id=99610.
17. Clara Miller, "The Equity Capital Gap," *Stanford Social Innovation Review* (Summer 2008): 45, www.nonprofitfinancefund.org/docs/2008/ssir_summer_2008_equity_capital_gap.pdf.
18. Heiner Baumann, "The Growth Capital Market in the U.S.," *Alliance* 10.1 (March 2005): 37; *Alliance Magazine*, 14 Apr. 2008, www.allavida.org/alliance/0503-pages37-39.pdf.
19. Christine W. Letts, William Ryan, and Allen Grossman, "Virtuous Capital: What Foundations Can Learn from Venture Capitalists," *Harvard Business Review* (March–April 1997), harvardbusinessonline.hbsp.harvard.edu/b01/en/ common/item_detail.jhtml?id=97207.
20. "The Reform of School Reform," *Business Week*, 26 June 2006, p. 72.
21. Porter and Kramer, "Philanthropy's New Agenda," pp. 121–130.
22. Kim Alter, Paul Shoemaker, Melinda Tuan, and Jed Emerson, "When Is It Time to Say Goodbye? Exit Strategies and Venture Philanthropy Funds" (September 2001), www.virtueventures.com/files/exitstrategy.pdf.
23. Letts et al., "Virtuous Capital," p. 5. See also Gregory M. Stanton, Jed Emerson, and Marcus Weiss, "Going Mainstream: NPOs Accessing the Capital Markets," Draft Rev., 26 Feb. 2001 ("Nonprofits often labor under the continual

cycle of annual fundraising efforts and are forced to finance their long-term operations with short-term funding strategies, such as annual grants, contracts, and subsidies"), www.redf.org/download/other/cmap_going.doc.

24. Dennis Prager, "Raising the Value of Philanthropy: A Synthesis of Informal Interviews with Foundation Executives and Observers of Philanthropy," Prepared for Jewish Healthcare Foundation, the Forbes Fund, and Grantmakers in Health, February 1999.
25. Clara Miller, "The Looking Glass World of Nonprofit Money," *Nonprofit Quarterly* 12, no. 1 (Spring 2005), www.nonprofitfinancefund.org/docs/Looking%20Glass,%20NPQ%20website.pdf.
26. Cynthia Gair, "Stepping Out of the Maze: Aligning to Improve the Nonprofit Capital Market," www.redf.org/publications-newsletter-old.htm.
27. Letts et al., "Virtuous Capital," p. 3. See also p. 6: "Many [NPOs] have been conditioned by the existing grant-seeking process to camouflage their organizational expenses and needs."
28. Baumann, "The Growth Capital Market in the U.S.," p. 38.
29. Miller, "The Looking Glass World of Nonprofit Money."
30. "Note on Starting a Nonprofit Venture," Harvard Business School, Case No. 9-391-096, p. 7 (rev. Sept. 11, 1992); Miller, "The Looking Glass World of Nonprofit Money" (cost of raising one dollar by small social service agency might cost 50 cents while a major institution with efficient fundraising might spend "only a fraction of a cent").
31. William F. Meehan, Derek Kilmer, and Maisie O'Flanagan, "Investing in Society: Why We Need a More Efficient Social Capital Market—and How We Can Get There," *Stanford Social Innovation Review* (Spring 2004), www.ssireview.org/articles/entry/investing_in_society.
32. Gair, "Stepping Out of the Maze."
33. Robert S. Kaplan and David P. Norton, *The Balanced Scorecard: Translating Strategy into Action* (Boston: Harvard Business School Press, 1996).
34. *Our Story of Impact*, 2005–2006 Annual Report (N.p.: New Profit, 2006).
35. "Future Impact," Venture Philanthropy Partners, 14 Apr. 2008, www.vppartners.org/impact/future.html.
36. "Our Reach and Growth," College Summit, 12 Sept. 2007, www.collegesummit.org/about/results-and-metrics/our-reach-and-growth.
37. "Our Impact," Jumpstart, 11 Sept. 2007, www.jstart.org/index.php?submenu=about_us&src=gendocs&link=Our_Impact&category=Main.
38. Ayana Douglas-Hall and Michelle Chau, "Basic Facts About Low-Income Children: Birth to Age 18," National Center for Children in Poverty, Mailman

School of Public Health at Columbia University, 14 April 2008, www.nccp.org/publications/pub_762.html.

39. Peter Frumkin. *Strategic Giving: The Art and Science of Philanthropy* (Chicago: University of Chicago Press, 2006).
40. Sidney Harris, www.cartoonbank.com/product_details.asp?sid=40967.
41. Peter Frumkin, *Strategic Giving*, p. 204.
42. Allen S. Grossman, "Jumpstart," Case 9-301-037, p. 14 (rev. May 17, 2002), http://harvardbusinessonline.hbsp.harvard.edu/b02/en/common/item_detail.jhtml?id=301037.
43. Allen Grossman, "Philanthropic Social Capital Markets: Performance Driven Philanthropy," *Social Enterprise Series* 12 (Boston: Harvard Business School, 1999).
44. Alana Conner Snibbe, "Drowning in Data," *Stanford Social Innovation Review* (Fall 2006): 39–40. Stanford University Graduate School of Business, Center for Social Innovation, 18 Sept. 2007, www.ssireview.org/articles/entry/drowning_in_data.
45. Meehan, Kilmer, and O'Flanagan, "Investing in Society."
46. Ibid.
47. Sue Hoye, "United Ways Raised More than $4-Billion Last Year," *Chronicle of Philanthropy*, 19 Sept. 2007, http://philanthropy.com/news/updates/3065/united-ways-raise-more-than-4-billion-last-year.
48. Mario Marino and Bill Shore, "High-Engagement Philanthropy: A Bridge to a More Effective Social Sector," Venture Philanthropy Partners, Community Wealth Ventures, 2004, 3 Aug. 2007.
49. Matthew Bishop and Michael Green, *Philanthrocapitalism: How the Rich Can Save the World* (London: Bloomsbury 2008), pp. 82–83.
50. Caroline Richmond, "Ron Rivera, Potter who developed a water filter that saved lives in the third world," Obituary, *The Guardian*, 16 Oct. 2008, www.guardian.co.uk/science/2008/oct/16/1; Sara Corbett, "Solution in a Pot," *New York Times Magazine*, 24 Dec. 2008, p. 38, www.nytimes.com/2008/12/28/magazine/28rivera-t.html?_r=2&ref=magazine.
51. "Goals for the Common Good: The United Way Challenge to America," www.liveunited.org.
52. Edna McConnell Clark Foundation, "An Experiment in Coordinated Investment: A Progress Report on the Edna McConnell Clark Foundation's Growth Capital Aggregation Pilot" (October 2008), www.emcf.org/pdf/gcap_progressreportOct08.pdf.
53. "About Us," Funders Together to End Homelessness, www.endlongtermhomelessness.org/about_the_partnership.aspx.

54. Jonathan F. Fanton, "Juvenile Justice Reforms," Letters, *New York Times*, 20 Aug. 2008, http://query.nytimes.com/gst/fullpage.html?res=9905E5D91731F930A1575BC0A96E9C8B63.
55. Miller, "The Equity Capital Gap," p. 42.
56. Steve Lohr, "Foundation to Offer $100 Million to Deal with Global Warming," *New York Times*, 9 Apr. 2007, www.nytimes.com/2007/04/09/business/09climate.html.
57. "Doris Duke Charitable Foundation Makes First Climate Change Initiative Grants," *Philanthropy News Digest*, 6 July 2007, http://foundationcenter.org/pnd/news/story.jhtml?id=181800021.
58. Connie Bruck, "Millions for Millions," *New Yorker*, 30 Oct. 2006, www.newyorker.com/archive/2006/10/30/061030fa_fact1.
59. Ibid.
60. Kleiner Perkins Caufield & Byers, "Initiatives: iFund," www.kpcb.com/initiatives/ifund/index.html.
61. William J. Holstein, "And Now a Syllabus for the Service Economy," *New York Times*, 3 Dec. 2006, www.nytimes.com/2006/12/03/jobs/03advi.html.
62. Austan Goolsbee, "Why Do the Richest People Rarely Intend to Give It All Away?" *New York Times*, 1 Mar. 2007, query.nytimes.com/gst/fullpage.html?res=9B05E0D81F3EF932A35750C0A9619C8B63&scp=2&sq=austan%20goolsbee%20%24100%20million%20ellison&st=cse.
63. "Lee Signs with Houston for Six Years, $100 Million," ESPN.com news services, 24 Nov. 2006, http://sports.espn.go.com/mlb/news/story?id=2674398.
64. Michael J. de la Merced, "Ripples from the Last Takeover Wave," *New York Times*, 4 Apr. 2007, query.nytimes.com/gst/fullpage.html?res=9907E0DD1E30F937A35757C0A9619C8B63.
65. "Arrillaga Gives $100 Million to Stanford in Largest Single Gift Ever from Individual," S*tanford Report*, 26 May 2006, news-service.stanford.edu/news/2006/may31/arrillaga-053106.html.
66. "Rhode Island: $100 Million Gift for Brown," *New York Times*, 30 Jan. 2007, www.nytimes.com/2007/01/30/us/30brfs-brown.html.
67. Thomas Landon Jr., "Court Rules for Grasso in Pay Case," *New York Times*, 9 May 2007, www.nytimes.com/2007/05/09/business/09grasso.html.
68. Cynthia Gair, "Roadmap #1: Strategic Co-Funding," Out of Philanthropy's Funding Maze, REDF, p. 3, www.redf.org/user/login?destination=node/548.
69. J. Larry Brown, Donald Shepard, Timothy Martin, and John Orwat, "The Economic Cost of Domestic Hunger: Estimated Annual Burden to the

United States," 5 June 2007, www.sodexofoundation.org/hunger_us/Images/Cost%20of%20Domestic%20Hunger%20Report%20_tcm150-155150.pdf.

70. National Anti-Hunger Organizations, "A Blueprint to End Hunger," 2008, www.bread.org/learn/us-hunger-issues/blueprint10-16-08.pdf.
71. Edna McConnell Clark Foundation, "An Experiment in Coordinated Investment."
72. Gair, "Roadmap #1."
73. Paul S. Schervish and John J. Havens, "A Golden Age of Philanthropy? The Impact of the Great Wealth Transfer on Greater Boston," Center for Wealth and Philanthropy at Boston College, 2006, www.bc.edu/research/cwp/meta-elements/pdf/goldenagephil.pdf.
74. Press release, GivingUSA Foundation, "U.S. Charitable Giving Estimated to Be $306.39 Billion in 2007," 23 June 2008, www.givinginstitute.org/press_releases/releases/20080622.html.
75. Marino and Shore, "High-Engagement Philanthropy."
76. "Results of KIPP Schools," KIPP, 15 Apr. 2008, www.kipp.org/01/resultsofkippsch.cfm.
77. United Way of Massachusetts Bay and Merrimack Valley, "Seeking Greater Positive Impact in Helping People: New United Way $100 Million Investment Plan Highlights Initiatives, New Organizations; Ties Traditional Funds to Specific Community Goals," 3 Aug. 2007, www.uwmb.org/press-room/07-Investment-Strategy.html.
78. Donald K. Stern and Nancy Gertner, "A Balanced Approach to Fighting Violence," *Boston Globe*, 21 Apr. 2007, www.boston.com/news/globe/editorial_opinion/oped/articles/2007/04/21/a_balanced_approach_to_fighting_violence.
79. Miller, "The Equity Capital Gap."
80. "About NFF Capital Partners," Nonprofit Finance Fund, 15 Apr. 2008, www.nonprofitfinancefund.org/details.asp?autoId=119.
81. SeaChange Capital Partners, 15 Apr. 2008, http://seachangecap.org/index.html.
82. Edna McConnell Clark Foundation, "$120 Million in Growth Capital Secured to Advance Opportunities for Low-Income Youth," www.emcf.org/who/presidentspage/index.htm.
83. James Surowiecki, *The Wisdom of Crowds* (New York: Random House, 2005).
84. Ibid., p. 102.