

# CHAPTER 1

## Beginning at the Beginning *Public Charities on the Economic Landscape*

*[Americans] have all the 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scene, in which nothing is, or ought to be, permanent; and they admit that what appears to them today to be good may be superseded by something better tomorrow.*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

Americans have long believed in the ability to perfect society, to solve problems by force of effort. Further, and despite enshrining individualism at the core of its psyche, Americans really do prefer to solve problems together rather than alone. There is a legendary mystique about the dust-covered lone sheriff who rides into town at sunset to rescue the community from the vile hands of evildoers. Legends make excellent movies; they just don't jibe with reality.

Citizen engagement, which is a recurring theme throughout this book, is the more common historical model of community problem solving. The lone voice in the wilderness is less a national role model than the "everyone-in-it-together" potluck dinner fund-raiser for social change.

### Thematic Summary

Common, voluntary action on the societal commons has a long history in the United States. But the size and nature of the "nonprofit sector"

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has changed markedly in the last two decades. Public charities are now a social and an economic force, and financial health and welfare is equally a social and an economic concern when economic turbulence threatens the underpinnings of all institutions.

The nation does not take well to fatalism; it believes betterment is constantly possible.

The exemption from taxation of money or property devoted to charitable or other purposes is based upon the theory that government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare.

*House Ways and Means Committee Report to Congress, 1939*

The role of public charities on the societal commons to pursue that betterment is as old as the nation itself. Private effort through charitable institutions to address community social needs had its roots in religious organizations, but the branches and leaves quickly grew in multiple directions and gave rise to nonreligious groupings of like-minded individuals focused on mutual aid. That early growth was not motivated by tax benefits. Formal tax-exempt status for nonprofit charities is relatively recent, beginning with the 1913 Revenue Act, which imposed federal corporate income taxes for the first time but explicitly exempted charities. Still, the legal roots of the concept of some type of tax relief for charities are older. The Tariff Act of 1894 and the Revenue Act of 1909 both contained foreshadowing of the 1913 initiative, indicating a long-standing concern among lawmakers that formal organizations established for the public good be treated differently from those organized for private gain.<sup>1</sup> The intent—at least in part—was to encourage private investment in meeting societal needs in order to avoid the public budget costs of equivalent government action. If private voluntary action could forestall tax expenditures, then the culture of U.S. governance could opt for the former over the latter.

## **The Present Departs from the Past**

All was quiet for about 40 years. By the 1950s, however, concerns were growing that large nonprofits were engaging in activities akin to private

commerce, and lawmakers began to take a closer look at the evolving collision course between tax exemption and the marketplace. Tax exemption was feared to be a veil behind which nonprofit organizations obtained market advantage, which they would then use for their own institutional interests quite apart from social needs. Despite *sotto voce* murmurings from commercial institutions and in the halls of Congress, there was no great public outcry, and policy concerns remained nascent. That was, in part, because the problem was largely invisible. According to testimony of the Internal Revenue Service to Congress in 1953, there were only 32,000 public charities in the United States, a number too small to be the focus of anyone's statistical attention.<sup>2</sup>

That was about to change, and change radically, in two ways. First, in midcentury, most secular nonprofits were not public charities. They were fraternal organizations, civic societies, and the like, so their numbers were small and engagement with service to members was large, but their interface with the larger public was small. Indeed, by the late 1960s only 32 percent of nonprofits were 501(c)(3) public charities. As recently as the early 1990s, that portion had risen to only 50 percent. As can be seen in Exhibit 1.1, however, the period of the last 16 years has seen an explosion of growth in the number of public charities and a shift in proportions. Now there are some 1.2 million public charities in the nation, a quadrupling in the last 25 years, and they represent nearly two-thirds of all registered nonprofits. Public charities are no longer invisible.

The second related change is the consequent economic role. Rather than simply the recipients of public largess, nonprofits are increasingly a

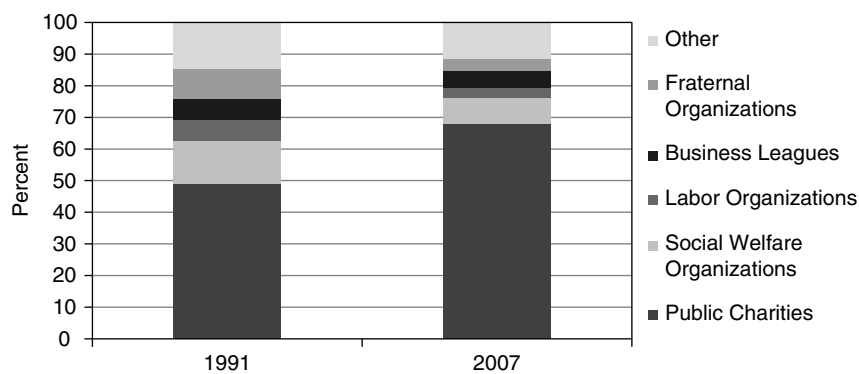


EXHIBIT 1.1 Change in Distribution of IRS Section (c) Organizations by Type, 1991-2007

Source: IRS.

powerful force in the economy. Before embarking on an examination of their economic roles, the structure of their revenue, and their health in trying economic times, however, three caveats are in order.

### A Complex and Poorly Documented Sector

First, the term “nonprofit sector” covers myriad types of organizations, from soup kitchens to cemeteries to the pension funds of unions and certain types of insurance companies. There are actually more than 25 IRS codes for nonprofit organizations, with varying implications for the tax treatment of their revenues and the monies they either make or that are donated to them. Exhibit 1.2 illustrates the relative size of each of the categories based on registrations with the Internal Revenue Service.<sup>3</sup>

For purposes of this book, the term “nonprofit” refers only to public charities that are categorized under section 501(c)(3) of the Internal Revenue Service tax code. This represents the nearly two-thirds of all nonprofits and 69 percent of the revenue in the total sector.<sup>4</sup> If only the median rate of growth of the last two decades holds (that is, growth every year is at the middle point of growth rates that have already been seen) there will be 1.7 million public charities by 2015.<sup>5</sup> Exhibit 1.3 depicts this growth. Extraordinary growth, in turn, means extraordinary youthfulness in the sector. Astonishingly, nearly three-quarters of those charities were created since 1980. Parenthetically, this robust growth has not been seen in other types

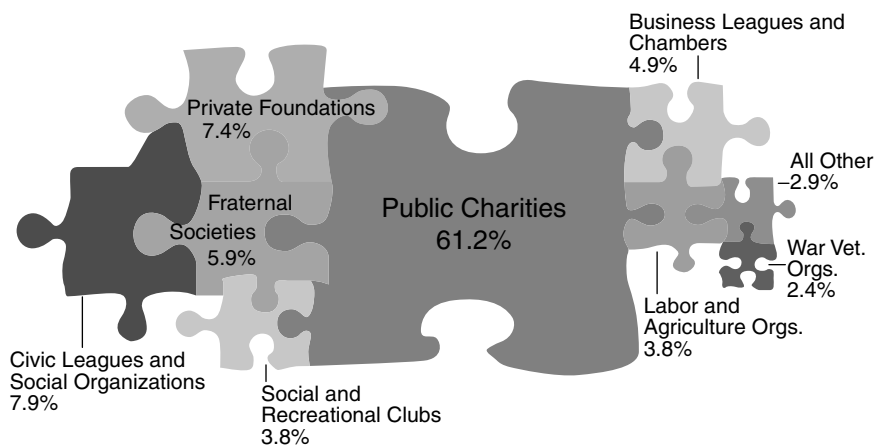


EXHIBIT 1.2 Distribution of All Types of Nonprofits

Source: IRS.

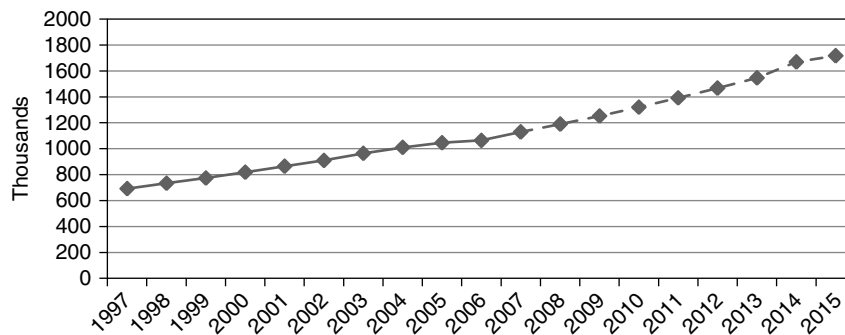


EXHIBIT 1.3 Number of Nonprofits, 1997 Projected to 2015

Source: 1997–2007 IRS; 2007–2015 author projection.

of nonprofits. The number of fraternal organizations, which dominated the sector in the mid-twentieth century, has declined by a third since 1991. So the proliferation has not been driven by some universal increase in the propensity to reject profit in preference to nonprofit among those who form organizations. Rather, growth seems driven by a combination of mission on the societal commons, and possibly, as is discussed in Chapter 3, “Philanthropy within Financial Structure,” increasing government reliance on private institutions for community problem solving.

It is important to be sure that terms are correctly and consistently used. A 501(c)(3) public charity is one that is organized and operated exclusively for religious, charitable, scientific, public safety, literary, educational, or amateur sports competition purpose; does not distribute net earnings to the benefit of private shareholders or individuals; and does not, as a substantial part of its activities, seek to influence legislation or participate in political campaigns.<sup>6</sup> A 501(c)(3) does not pay taxes on its net balance at the end of the year (although, as noted later, it must pay taxes on unrelated business income), and donations to it by individuals and organizations are deductible from income for purposes of the donors’ income tax calculation.

Narrowing the topic to this subset of “nonprofits” helps little, however. The universe of public charities is itself exceedingly wide. It encompasses huge institutions, such as Harvard University and the Memorial Sloan Kettering Cancer Center, with hundreds of millions of dollars in income and billions of dollars of endowment funds; and small institutions, such as halfway houses and storefront clinics with only tens of thousands of dollars of income and no endowments at all. Nonprofits are half of the nation’s hospitals, a third of its health-care clinics, 80 percent of its family and children’s centers, and nearly half of its universities.<sup>7</sup> Generalizations about the public charity subsector of the nonprofit sector are, therefore, difficult.

Where possible and when necessary, this work will qualify its analysis by controlling for organizational size.

The data on nonprofit finance are imperfect at best. There is irony here. As noted below, nonprofit organizations represent the third-largest segment of the U.S. economy after the wholesale and the retail trade. Little is known with any precision that reflects the traditions of charity in the country. The historic policy and public attitude has been that organizations selflessly serving the public good should not be held to overly rigid reporting standards. The assumption appears to have been that because these institutions were largely supported by private voluntary contributions and volunteer labor, burdensome financial reporting was, at a minimum, unnecessary. Indeed, demanding rigorous reporting standards could even be seen as something of a violation of the compact of public trust between the people and those institutions that addressed societal ills.

The problem with the data is made even more complex because tax exempt public charities that are part of religious institutions do not need to report to the IRS at all. So we do not know how many religiously affiliated public charities there are, the scope of their operations, or their financial size or structure. Yet a third of private giving flows to religious institutions.<sup>8</sup>

In addition, estimates of giving are based on tax reporting. Individuals may contribute goods, services, and cash to public charities without bothering to include itemized tax forms. The dollar dropped into the firefighter's boot at the corner of Main and Elm, the value of the six-foot hoagie donated to the little league team after a hard-fought championship game, the dollar value of volunteer time—such contributions to the public good through public charitable nonprofits are not captured in official data sets.

Finally, new mechanisms of giving, for example, cause-related marketing (CRM), do not come from philanthropies or philanthropic resources at all. Rather, these revenue streams originate in other budgets, in the case of CRM, in corporate marketing budgets. The dollar value of these new “public good” strategies is not found in any data set, and their presence on the societal commons is often not part of financial estimates in the nonprofit sector at all.

It is important to note that improvements are just over the horizon. Starting in 2009, the Internal Revenue Service will require nonprofits, including small nonprofits, to file their returns on a revised Form 990. The new reporting form asks for more financial and management detail than the previous form. For example, elected officials attending or honored at events must be declared, speaking honoraria revealed, and linkages between these officials and activities or individuals in the nonprofit disclosed. These detailed data will not be available for several years and will not allow comparability to past years for purposes of trend analysis. Still, going forward, the ability to

understand the financial structure of tax exempt organizations will be greatly enhanced within five years.

So the data sets used in this work are flawed and can only sketch the outlines of the financial dimensions and structure of the sector. The data sets provide an order-of-magnitude sense of their relationship to the economy, which, in the end, likely understates the importance of the sector overall.

## **An Economic Engine**

Nonprofits represent \$1.1 trillion in annual economic spending, the third-largest portion of the economy after the wholesale and the retail trades.<sup>9</sup> Nonprofits of all types represent about 10 percent of national employment, a portion that rises to 17.6 percent in the District of Columbia, 16.5 percent in Vermont, and even 15.6 percent in New York.<sup>10</sup> Indeed, through 2006, nonprofit employment grew faster than overall employment in 46 of the 50 states.<sup>11</sup>

Although no comprehensive data are available nationally, a number of states and communities have examined the full economic effect of their public charitable sectors. Most of this work focuses on education and health care because these service areas represent the largest nonprofit institutions in terms of employment, revenue, and assets.

Several examples suffice to illustrate the degree to which public charities are no longer simply recipients of donations for the poor and needy. They are important sources of jobs, investment, goods, and services.

The arts in the United States generate an estimated \$134 billion in economic activity each year, supporting 4.9 million jobs, of which only 2 million are the artists.<sup>12</sup> The Sundance Film Festival produces \$60 million in annual revenue for Park City, Utah, fueling jobs throughout the local economy.<sup>13</sup> Hospitals represent a quarter of a trillion dollars in annual wages in the U.S. economy, with rates of increase more than double those in the economy overall.<sup>14</sup> Colleges and universities play a similar outsized economic role. Every campus job is estimated to create 1.6 jobs in the surrounding community, and every dollar spent by an institution of higher education is estimated to generate \$1.38 of additional expenditures.<sup>15</sup>

The economic role is not just one of spending and jobs, however. In 2007—admittedly before the market crisis of 2008–2009—the 785 U.S. universities regularly sampled by the *Chronicle of Higher Education* had endowments valued at \$411 billion.<sup>16</sup> Between 1995 and 2005, the total assets of public charities rose from \$843 billion to \$1.98 trillion, an inflation adjusted increase of 84 percent. The assets of public charities represent two-thirds of the assets of all types of nonprofits combined.<sup>17</sup> The nonprofit sector is not just a spender of money; it is an aggregator of capital.

Thus, the health of the nonprofit sector is important to the health of the overall economy. And the health of the economy impacts nonprofits in more ways than simply in the level of the contributions they receive from private citizens and philanthropists. Nonprofits as economic entities must develop revenue strategies for economic decline that integrate philanthropy and fund-raising into broader strategies.

### **Nonprofits as Masters of Their Own Fate in Economic Turmoil**

The charitable sector in the United States has grown from its original roots as a matter of religious commitment to the poor to an \$800 billion economic engine. The following chapters examine the role of public charities in the economy, the structure of the revenues and assets that undergirds their operations, and the fate of public charities when the economy, national and local, falls on its regular cyclical hard times.

When economic crisis hits—as it has with a vengeance in the 2008–2009 recessionary period—there is much concern for the health of the nation's nonprofits. That concern is warranted because the nonprofit sector continues to provide much of the safety net for the disadvantaged. But to see nonprofits as simply passive victims is a misperception. Public charities are not victims of economics. They are part of the nation's economic structure. They are (or ought to be) masters of their own destiny, vibrant economic actors with a wide range of revenue options and strategies. Even with robust plans and clear preparation, nonprofits, as economic actors, will not necessarily suffer less than other parts of a stressed economy. But they need not suffer more.

The structure of this book traces the arc of change and its implications for nonprofit revenue in several parts.

Chapter 2 places the discussion of revenue in context. Although the discussion is about revenue, and thus about money, it is important to understand that philanthropy, and the nonprofits it supports, are not simply about money. The sector is a critical anchor of civil society, and the philosophy that underpins that role is critical to keep in the forefront of thought, even as attention turns to money.

Chapters 3 through 5 address the changes in the structure and expectations of the nonprofit and philanthropic sector over the last two decades. These changes provide the environment within which revenue strategy can be developed. The emphasis in these chapters is on rising complexity in the sector, but, more important, with the opportunity that comes with complexity.

Chapter 6 then addresses the economy itself and its relationship with the nonprofit sector. Cycles are actually beneficial to economies, and therefore



are to be expected. The relationships to nonprofits and philanthropy are not clear cut, but general trends can be anticipated. Therefore, forward-looking strategy is possible.

Chapter 7 sets out an analytic framework for conceptualizing strategy. Complexity requires some mechanism for arraying options and then aligning them with capacity and the prioritization of choices. The analytic framework provides this tool.

Chapters 8 through 10 address financial strategies for coping with or recovering from economic hard times.

Chapter 11 provides a concluding thought about the imperative of taking on these difficult strategy tasks in the context of civil society.

Chapter 12 contains the commencement address of Michael P. Hoffman to the 2009 graduating class of Malloy College, an address that underscores many of the themes in this book.

## Notes

1. P. Arnsberger et al. "A History of the Tax Exempt Sector." *Statistics of Income Bulletin*, (Winter 2008).
2. U.S. House of Representatives, 82nd Congress, 2nd session, 1953. "Hearings before the Select Committee to Investigate Foundations and Comparable Organizations." U.S. Government Printing Office, 64.
3. U.S. Internal Revenue Service, Business Master Files, Exempt Organizations, various years from raw data.
4. A. Blackwood, K. T. Wing, and T. H. Pollak. *The Nonprofit Sector in Brief, 2008*. (Washington, DC: Urban Institute National Center for Charitable Statistics, 2008), 2.
5. Of course, this does not correct for actual operations. Nonprofits register when they are created. There is no mechanism for constantly monitoring their actual operational scope. That a nonprofit exists at a point in time does not mean that it is actually operational at some subsequent point in time.
6. Publication 557, Internal Revenue Service, June 2008.
7. L. M. Salamon and S. L. Geller. "Communique No. 11: Nonprofit Policy Priorities for the New Administration." Johns Hopkins University Center for Civil Society Studies, Listening Post Project, December 2008.
8. *Giving USA*, 2008. Glenville, IL: Giving USA Foundation, 2008.
9. Blackwood et al 2008., op cit.
10. L. M. Salamon and S. W. Sokolowshi. "Employment in America's Charities: A Profile." *Nonprofit Employment Bulletin* 26, Johns Hopkins Center for Civil Society Studies, 2006, 6.

11. State Nonprofit Economic Data Bulletins (various states) from the Nonprofit Employment Data Project, The Johns Hopkins University Center for Civil Society Studies.
12. "Arts and Economic Prosperity." *Americans for the Arts* (2002), [www.AmericansForTheArts.org](http://www.AmericansForTheArts.org).
13. R. Pogrebin. "Saving Federal Arts Funds: Selling Culture as an Economic Force." *New York Times*, February 16, 2009. C1.
14. S. Raymond. *Non-Profit Hospitals in America: Lives, Jobs and Philanthropy* (New York: Changing Our World, Inc., 2007), 43.
15. S. Raymond. *Enabling the Progress of the Mind: The Future of Philanthropy and Higher Education in America* (New York: Changing Our World, Inc. 2008), 62.
16. Ibid., 66.
17. Blackwood et al., op cit.