CRC CAPITAL RESEARCH CENTER

Organization Trends

# Rating the Charity Raters

*Measuring Charity Effectiveness is More Than a Matter of Money*

By Paul Niehaus

*Summary: Websites rating stocks and mutual funds like Morningstar.com have inspired imitators in the nonprofit world. There are now websites that rate charities to help you decide which ones to support. Are they any good?*

CharityNavigator.org and MinistryWatch.com are two leaders in a new group of web-based charity watchdogs that evaluate the financial performance of nonprofits. Currently, Charity Navigator looks at 2,500 nonprofits of all sorts, while MinistryWatch looks at 500 specifically Christian ministries. Both groups want to help donors make wise giving decisions and make philanthropy more efficient and accountable. In practice, this means both give ratings to the charities in their databases.

Just how big are the stakes? Despite the economic downturn, individuals gave $184 billion to charity last year. All charity contributions, including foundation and corporate contributions and bequests, totaled $241 billion in total. That's substantial – 2.3 percent of GDP. If the new charity-raters actually guide donor decisions, they could shift income in the nonprofit sector. And if they increased the confidence of donors by making charities more accountable, they could increase total giving. Both Charity Navigator and MinistryWatch have attracted lots of press attention; Charity Navigator reports that over 60,000 people visited its site last December, the month when Americans are most generous.


Donors want to give to charities that meet the needs of their "clients." But how can a donor tell if the charity is doing a good job?

MinistryWatch's financial ratings are the more sophisticated; its founders have backgrounds in stock analysis and mutual fund management. By contrast, the Charity Navigator rating system is less analytical and favors big institutions with substantial assets and cash-flow. Charity Navigator executive director Trent Stamp worries that an expanding nonprofit sector has no incentive to become more efficient. He wants more government regulation of charities and finds it "outrageous" that they are "accountable to no one but the whims and needs of the individual donor."

Both websites have one crucial failing that has nothing to do with what they rate. It's what they don't rate. Neither gives you

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**CONTENTS**

Rating the Charity Raters *page 1*

Briefly Noted: *page 6*

what has got to be a charity's bottom line – how much *good* does it do? Both sites know this and admit it. Both say a charity's financial condition is only one consideration that should affect a donor's decision. But unless you know what a nonprofit actually accomplishes, you have to wonder if financial ratings are helpful at all. It is an unfortunate fact that many of the best-funded and most efficient nonprofits in America today exist to promote an explicitly liberal, big-government agenda.

### The Wisdom of Solomon

When donors contribute to nonprofits, they typically want to give to groups that will provide goods and services to improve the welfare of their beneficiaries (hospitals, food banks), enrich their future prospects (schools), advance their tastes (art museums) or in some way make their lives "better." But how can a donor tell whether a particular charity will do the best job at maximizing the "good" the donor wants to accomplish?

This isn't too hard to do in the for-profit sector. Investors look at prices and profits to measure which firms provide the right type of goods to the right people in the right amounts at the lowest cost. Investors only need to know which firm has made the most profits. That helps them decide whether the firm is likely to keep making profits. Stock and mutual fund ratings services like Morningstar.com help investors by keeping track of profits and by devising scorecards that make a prediction of future profitability.

Websites like Charity Navigator and MinistryWatch want to imitate the for-profit sector in this respect. But decision-making in the nonprofit sector is far more difficult. That's because there is no single piece of information that describes the effectiveness of all nonprofits in the way *profit* describes effectiveness for all for-profits.

Giving things away *efficiently* is harder to do than selling things. Suppose you want to give away a computer, and two people express interest. How do you choose who will receive it?

There is a classic Biblical story illustrating this point. Two women come to King Solomon, both claiming to be the mother of the same baby. No one has been able to resolve the dispute. Solomon, in a brilliant demonstration of regal cunning, orders that the baby be cut in half and a portion distributed to each woman. On hearing this, the true mother yields and offers to let the false claimant take the child rather than see it killed. Solomon then awards the child to its rightful mother. Solomon's resolution illustrates the essence of wisdom.

Unfortunately, this kind of thinking is required to give well to charity. If Solomon had put the child up for sale in a for-profit system, there is no reason to expect the highest bidder would be the real mother, especially if she lacked the ability to pay.

Or compare a food bank to a grocery store. The food bank gives goods to people who are unable to pay for them. How does the manager know who needs the food most? What type of food should they get? How much of it and in what proportion? (More beans, less meat?) At the grocery, the manager seeks whatever combination is most profitable. By contrast, the food bank earns no profit and so has no obvious information base on which to make decisions. Unless he is Solomon, the food bank manager has to act like a central planner.

The lack of information also creates problems for donors. How does the donor decide which charity does the best job achieving a mission the donor supports? No single piece of information enables donors to efficiently allocate their contributions so that both donors and beneficiaries are best-off. And because the underlying information is limited, ratings produced from that information are also limited. Ratings can summarize and interpret information, but they can never create it.

### Classification and Comparison

Both Charity Navigator (CN) and MinistryWatch (MW) classify charities by group before attempting to compare their effectiveness. This is unnecessary in the for-profit sector because it's easy to compare disparate organizations. Which is the better investment—the oil drilling company or the pharmaceutical manufacturer? To find out you only need to know which is more profitable. Nonprofits can't be compared this way (homeless shelter or youth center?), so charity raters first attempt to classify before they compare: museums with museums, schools with schools, food banks with food banks.

But classification is difficult. Is the Salvation Army a religious organization or a social services program? And what are the significant categories?

Charity Navigator and MinistryWatch use different classification systems, which makes it even more difficult to evaluate their ratings. CN mostly relies on IRS activity codes. For instance, it uses two "Religious" subcategories—"Religious Activities" and "Religious Media and Broadcasting." In contrast, MW uses 12 categories to compare different kinds of Christian ministry, including "Leadership Training," "Fellowship Evangelism," "Evangelism," "Evangelism Support," and "Advocacy."

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The founders of MW hope "a fully developed nonprofit information marketplace will eventually offer donors a myriad of tools and rating systems to help them with their giving decisions." But when charity watchdogs have different ideas about what is important, how likely is it that donors will be able to sort through their different ratings systems?

Perhaps the charity raters could support an "industry-standard" classification system and add extra dimensions of their own. The IRS codes are one possible standard. Another, called the National Taxonomy of Exempt Entities (NTEE), has been developed at the National Center for Charitable Statistics and is already being used by Guidestar.org, the largest online database of nonprofits.

### Rating "Efficiency"

Charity Navigator rates the "financial efficiency" of charities in common-sense terms. It measures "fundraising efficiency" (how much a charity spends for each dollar it raises) and it lists the percentage of the charity's budget that goes for "administrative expenses," "fundraising expenses," and "program expenses." Obviously, the more money going to program expenses, the better the rating.

Unfortunately, Charity Navigator skews its efficiency ratings by what it calls an "organizational efficiency score adjustment." This is nothing but a penalty that lowers the rating of charities that spend more than they take in over a three-year period. It doesn't matter how the charity incurs its deficit—maybe it fed more homeless during a recession or made a major capital investment on a school campus. According to CN, a deficit over three years counts as an indicator of poor management. Why? CN asserts that charities "should not outspend their means." Why not? Should charities hoard during hard times or discourage investment in social assets? And why should deficits imply an *inefficient* delivery of goods and services and lead to a lower rating? If the mission of charities is to produce non-monetary returns for beneficiaries and donors, the very concept of "deficit" bears scrutiny.

MinistryWatch does a better job in the areas of fundraising and resource allocation because it weighs risks against returns, a more sophisticated method of financial analysis. Unlike some groups, it also believes it is important to distinguish funds raised by contribution from revenue from other sources (sales, fees and government grants). However, some donors may prefer CN's easier-to-understand metrics. Either website will give you a basic sense of how effectively charities obtain funding, and how much of their budget goes to programs you support, rather than to overhead.

One other point: In the for-profit sector all competition is relative. Successful for-profit firms outperform their peers; they do not aim to reach a fixed benchmark. MW approximates this standard by giving *relative ratings*. A charity receives five stars if its fundraising is more efficient than 90 percent of the other charities in the database. CN gives *absolute ratings* – e.g. when a charity's fundraising efficiency reaches a particular measurable level it automatically rates five stars. That more simplistic approach gives charities less incentive to innovate and improve their operations.

### Capacity & Growth

Before you buy a company's stock you want to know its prospects. Will it still exist in ten years? Will its assets grow or shrink? The answers affect your decision because you become an *owner* whose return depends on the company's future value.

Charity Navigator seems to think donors should make a similar assessment of the long-term prospects for a charity—what it calls charity "capacity." According to Trent Stamp, "Most charities operate like for-profit companies...Why are these organizations any different than for-profit companies?" That's why CN rewards charities that accumulate cash while expanding the scale of their operations. OK, maybe savings and growth are good indicators of a charity's lifespan. But why should you care? When you make a gift to a charity you neither buy nor own anything. The fact that the charity will still be going strong a decade later is not important to you *per se*; longevity is only important if it increases the social impact of your donation. But does it?

Here are some issues to consider concerning the institutional life of charities.

**The time value of money.** Charity Navigator argues that charity managers who would rather invest their contributions for the future than spend them now "will generate both short- and long-term results for every dollar they receive from givers." This is untrue. A dollar has impact only once, when it is spent. When should that be? If a charity saves money, it earns interest on its funds. This means that your initial contribution can be used to deliver more social goods in the future. But if the charity spends money today, that money also earns a return – a social return. For example, raising a child out of poverty and providing him with an education *today* provides benefits *tomorrow* when the child becomes a productive citizen, raises a family, and so on. A widely-noted report from consultants at McKinsey & Co. suggests that "the net present value of future spending is often less than the value that would be created by investing in solving problems today." In such cases charities with high "working capital ratios" (i.e. enough liquid assets to last several years) are wasteful.

**Institutional self-preservation.** Many nonprofit managers and employees have self-interested reasons for wanting to make sure their organization has a long life: They want to keep their jobs. As a result, they have a natural bias towards conservative budgeting rather than spending money to meet immediate needs. There is no reason for donors to encourage this behavior, especially since they have no stake in the organization's future. Government bureaucracies are not the only institutions that tend to perpetuate themselves—it's a feature of the nonprofit sector as well.

**Dependency.** Charity Navigator's capacity ratings are supposed to show "how well that charity is positioned to pursue long-term, systemic change." Watch out—

this is the language of welfare. True charity meets immediate needs without creating long-term dependency. But charities that can be counted upon to provide the same services freely forever invite dependency. And rather than welcoming the donor's gift, they may come to expect "their" annual grant. Donors should question this attitude.

**Donor Intent.** The goals and activities of a nonprofit may change over time: circumstances change and new managers take control. Although nonprofits are legally incorporated in order to produce public benefits, they have considerable leeway in deciding how they use their resources. The greater the amount of time that elapses between your donation and its use, the less likely it is that the money will be spent on the cause for which you gave it. This accountability problem has been well-documented by Capital Research Center Visiting Fellow Martin Wooster.

How important is it for the Red Cross to be ready to address the next disaster if it is unwilling to accept the wishes of donors to address the current one?

Not every charity watchdog needs to consider "capacity" issues. Indeed, the American Institute of Philanthropy, another charity watchdog, penalizes nonprofits with large reserves ("That's just proving that the group may not need your money," explains AIP president Daniel Borochoff.) Moreover, many members of Congress have begun urging foundations to increase their giving. A bill currently pending in Congress, the "Charitable Giving Act of 2003," would prevent foundations from including administrative expenses in calculating their required annual contributions, which is five percent of assets. If implemented, the law could increase charitable donations by more than $4 billion per year. Rep. Roy Blunt (R-MO), a bill co-sponsor, says, "If we are going to encourage charitable giving, it makes sense

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When donors are well-informed, they will give to well-managed charities that have long lives. But Charity Navigator gets it backwards: it assumes that charities with long lives are likely to be well-managed. Stamp even appeared on the Fox News cable television show *The O'Reilly Factor* to defend the Red Cross after it refused to pay out money donated to help the victims of 9/11: "This is a well-managed organization from a fiscal standpoint... that is well-positioned moving forward to address the next disaster that happens." that one of our strategies [is] to ask those groups that have been created for the purpose of charitable giving to give."

Surely the important question to ask is: How much good work can a charity do with its assets? MinstryWatch understands the trade-off: "Nonprofits must continually make tough decisions about whether to invest resources in additional assets that will benefit future operations or use more of their resources to increase activities more directly today. Striking this balance can be one of the biggest challenges faced by nonprofit management." MinistryWatch gives improved ratings to charities that spend more on current programs rather than over-invest in fixed assets.

Of course, living hand-to-mouth is not an effective way to run a nonprofit. But hoarding cash is also a mistake. An optimal level of saving has to balance institutional *stability* against the *quick delivery* of resources to the intended beneficiary. The problem is that nonprofits have no easy way to know how to achieve this balance.

## Means and Ends

Despite its good intentions, the built-in biases of Charity Navigator weaken the value of its ratings. Charity Navigator gives its highest marks to nonprofits that achieve "consistent growth" or "positioning to achieve long-term, systemic change." That kind of ratings system rewards big and growing institutions.

How important is the quantitative analysis of nonprofits? A strong financial performance is good for any nonprofit, but it's only a means to an end. Suppose you know that 90 percent of every dollar you give a favorite charity is spent on its programs. Wonderful. But how important is the program? How much good does it do? Donors who become preoccupied with a charity's financial condition may neglect the more difficult issue of evaluating the program's intention and impact?

CN's rating system won't help anyone who wants to know more about a charity's political and social agenda. For instance, the "top ten" CN-rated charities include the number one-rated Trust for Public Land (TPL) and the seventh-ranked Wildlife Conservation Society (WCS). These groups are undoubtedly prosperous and well-established, according to CN measures of financial "effectiveness" and organizational "capacity." Both groups get high ratings in part because they have grown rapidly. WCS spending has risen annually by almost 12 percent during the past four years; at TPL the average annual increase is a whopping 32 percent. And

both groups have plenty saved for a rainy day—their net assets are $552 million and $325 million respectively.

But both the Wildlife Conservation Society and the Trust for Public Land are advocacy groups: they argue for more government regulation and spending on the environment. WCS opposes oil exploration in the Arctic National Wildlife Refuge, urges Congress to spend taxpayer dollars on overseas land preservation, and would have the U.S. government pressure foreign governments to put restrictions on logging, mining, and farming. Developing countries that are least able to afford environmental luxuries reject the heavy costs that many of these initiatives would impose on them.

The Trust for Public Land is less a private conservation group than it is a nonprofit middleman promoting taxpayer funding of federal, state and local conservation programs. Since 1996, it claims to have lobbied for more than $35 billion in state and local conservation-related funding, including $18 billion for land acquistion and restoration. One of TPL's primary missions is to transfer private property to government control. According to its web site: "Because TPL does not own or manage land over the long term, there must be a government agency or organization willing or able to assume ownership of the land." In the fiscal year ending in March 2002, TPL boasts of acquiring more than $400 million worth of private property. Transactions from land sales to the government no doubt represent a considerable portion, if not most, of the $126 million in revenue TPL generated that year. In addition, TPL benefits from federal funding. In 2002, TPL received nearly $1 million in grants from the EPA and the Interior and Agriculture departments. TPL also supports "smart growth" land-use policies that undermine private property rights and drive up housing costs in the name of halting urban and suburban "sprawl." These policies hit minorities and the working poor hardest.

## Rating Nonprofit Advocacy and Public Policy

Capital Research Center offers a different kind of nonprofit rating. CRC believes donors should look at a nonprofit's mission and tactics, not just its financial health. CRC publications and its website database (www.capitalresearch.org) provide a *qualitative* assessment of nonprofit advocacy and public affairs groups that take positions on individual freedom, the importance of markets, and the role of government in the economy. We believe donors should consider these issues before they write a check to a charity that proposes to defend children, protect animals, preserve the land or support the arts.

In fairness, both Charity Navigator and MinistryWatch encourage donors to understand the mission of the charities they rate. MW does the better job: It offers summaries of each charity's accomplishments, which it puts next to its "star" ratings. By contrast, CN provides only a vague disclaimer hidden away on its "Frequently Asked Questions" web-page: "We do not currently evaluate the quality of the programs and services a charity provides. As soon as we develop a methodology for doing so, we will. For now, however, we limit our ratings to an analysis of a charity's financial health, and we encourage givers to research a charity's programs and to make their own assessments as to their quality." This admission is hidden behind CN's display of metrics. Charity Navigator should be more candid about the limitations of its ratings system.

## Conclusion

Alexis de Tocqueville believed the United States was unique among all nations because we relied on private charitable organizations to solve our social problems: "Nothing, in my opinion, is more deserving of our attention than the intellectual and moral associations of America." Americans retain the voluntary civic-mindedness that made us unique in his eyes, and our nonprofit sector is still vibrant despite the encroachments of government. We should welcome healthy debate over how to increase the effectiveness of charity.

Charity Navigator and MinistryWatch offer competing models for evaluating nonprofits. By putting their evaluations online, they seek to increase nonprofit transparency and accountability and help donors better understand how their money is spent. Eventually, this may give donors more confidence to make larger contributions to charity.

But rating carries risk. Donors should know that not all charities want what is best, and good work can't be quantified. People like simple answers and are attracted to "star" rating systems like Morningstar.

Too bad nonprofits just aren't that simple.

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# **Briefly**Noted

**Miguel Estrada**, nominated by President Bush in May 2001 to the D.C. Circuit Court of Appeals, withdrew his name from consideration for the post on September 4. A coalition of liberal activist groups, led by the **Alliance for Justice** and **People for the American Way (PFAW)**, joined Senate Democrats to thwart his confirmation. The Republican-majority Judiciary Committee voted to send his name to the full Senate for a vote but supporters failed in a half-dozen attempts to win the 60 votes needed to end a Democratic filibuster against Estrada. PFAW said Estrada's decision will help focus attention on "other Bush nominees who have extremely troubling records of ideological extremism and right-wing judicial activism." PFAW has singled out two other Bush nominees to the D.C. Court of Appeals, Brett Kavanaugh and Janice Rogers Brown, as examples of unacceptable judges "who would turn back the clock on civil rights, privacy and reproductive rights, environmental protection, religious liberty, and much more."

**People for the American Way (PFAW)** also attacked **Washington, D.C. Mayor Anthony Williams** for supporting a private school voucher program for DC public schools. The program, contained in congressional legislation, the DC Parental Choice Initiative, would authorize $15 million annually for five years to fund vouchers of up to $7,500 for about 2,000 low-income city children to attend private schools. PFAW president Ralph Neas was especially angry that Williams spoke to the **American Legislative Exchange Council (ALEC)**, a coalition of free market state legislators, to explain his support for school choice. Neas said ALEC "espouses an anti-government free market extremism that is directly counter to the interests of the District of Columbia." Mayor Williams dismissed Neas' remarks: "Part of democracy is a free exchange and competition of ideas. I don't have to agree with everyone and their views."

On July 19, a coalition of 29 groups (they ranged from consumer advocates to religious organizations) "ticketed" 15,000 sport utility vehicles in the Baltimore/Washington area. Mike Tidwell of the Takoma Park, MD-based **Chesapeake Climate Action Network** said the educational campaign, involving 150 volunteers, was designed to pressure Detroit automakers into building better SUVs that "protect public health, enhance national security, and spare our planet from the potentially catastrophic crisis of rapid global warming." The bright yellow "tickets" contained detachable pre-printed postcards that drivers could send to General Motors and Ford challenging them to build cleaner cars.

The U.S. Supreme Court is expected to quickly decide on the constitutionality of the **McCain-Feingold campaign finance reform law,** which has been challenged by a diverse group of nonprofits, including the **American Civil Liberties Union** and the **National Rifle Association.** On September 8 the Court heard oral arguments that a ban on unlimited donations to political parties (known as "soft money") and restrictions on political advertising violate the Constitution's guarantee of free speech. Former independent counsel Ken Starr said the law "intrudes deeply into the political life of the nation" and "goes too far" by hamstringing local political parties and hurting grassroots groups. Justice Antonin Scalia agreed, saying, "The right to speak includes the right to speak in association with others." A liberal faction – Justices John Paul Stevens, David Souter, Ruth Bader Ginsburg and Stephen Breyer – is believed to be more sympathetic to the law.