

## A Method for Measuring and Partially Testing ‘Charitability’

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### *Third of Three Parts: Some Complexities*

In this series so far, I have suggested that it is possible to test “charitability” — at least in terms of transfers of resources from some class of donors to some class of recipients — by using a balance sheet approach to identifying how those donors and recipients match up. After all, they should be equal in size. Now I will examine two additional complications — past charitable contributions and transfers from government — and then conclude by reexamining some of the objections to the approach I have suggested.

### **Net Worth Deriving From Past Charitable Transfers**

Not all financial and labor contributions are transferred immediately in the year given. Often some amount of financial, real, and labor charitable inputs yield a surplus that is saved by a charity — providing assets and income that can be used later for charitable purposes. Current charitable uses of funds may then derive from those past charitable sources of funds. Take the case of a private foundation that pays its staff market wages and its board members market-type compensation. If the foundation also receives no new charitable contributions and has no volunteer labor, then in this example it has no current sources of charitable transfers. By all accounts, it is a charity, but I still contend that applying the balancing exercise would help give it some clue as to the extent of its charitability. Is it only the past charitable contributions that give it that status? Does anyone provide any additional source of transfers (through contributions of time, effort, or work at below-market wages)? Do some people get more than market compensation and essentially decrease the charitable output of the organization?

Indeed, the great danger faced by an organization with built-up net worth is that it is quite possible for its staff and board to *currently* provide negative charitable value added, even though there are positive current transfers. Continue with the case of the private foundation presented above, only now add the assumption that it pays some of its staff more than market wages, perhaps because friendly boards want to pay extra to some top officers, perhaps because the foundation represents nothing more than a publicity front by a sports or media star

who turns around and uses the assets mainly to pay relatives to run it, or perhaps simply because it is run inefficiently, using the endowment to protect workers who could not so easily get as high a wage for their efforts elsewhere.

Consider also a hospital that has no current source of charitable transfers, but manages to pay an undeserved bonus of \$1 million to its head when he is forced to resign because of bad management. Suppose additionally that its real estate is worth \$100 million and this net worth has been accrued over time because of past charitable contributions. At a 5 percent interest rate, the rental saving from the real estate yields a flow of \$5 million not available to a competitive profit-making hospital, which must pay that amount to lenders or equity owners who put up the capital contributions for its real estate. Assuming market prices and wages for everything the nonprofit hospital does, then relative to the profit-making hospital it might well succeed in using its extra \$5 million to provide \$4 million in extra indigent care and \$1 million more in excessive compensation. If full asset and liability accounting is performed, however, the net charitable value added for that year’s operation is -\$1 million (which equals the loss in present value terms of charitable transfers that could otherwise have been provided over time). At the same time, there are positive transfers on a current flow basis of \$4 million.

By all accounts, the foundation and nonprofit hospital are charities in the strict legal sense. Yet this balancing exercise helps reveal that neither has achieved its possible level of charitability.

### **Government Transfers**

The government also performs many transfer functions. Often it will contract out for the provision of its services through both charities and profit-making organizations. Although we have shown that almost no charities operate with zero private transfer sources of their own, it is possible, at least in theory, for a charity to rely only on government transfers to cover services for which full market fees are charged. If a hospital relying on government funds meets two charitable qualifications — its activity, like healthcare, is among those defined as potentially charitable, and it accepts the nondistribution constraint — it likely would or could be defined as a charity in many countries.

Still, the extent of charitability along the transfer line is worth knowing. For instance, government might prefer to grant contracts to charities that are themselves trying to maximize net private transfers. Why? The government dollar may then leverage more support through private contributions of money and time. As a matter of contracting, the government may also gain from the experience of the charity that makes net transfers of its own, since in the end the government is attempting to achieve similar goals. Thus, for instance, much foreign aid flows through international charities because their charitability, along

the dimensions I have outlined, may indicate to the government that they get a lot of bang out of each buck at their disposal. My point again is that some of this is *measurable*, at least in part, through a balance sheet exercise.

Some charities get their financial support only from government. Among housing and shelter groups, for example, the National Center on Charitable Statistics indicates that 55 percent reported no contributions of money or property in 2003. Many rely on sources like the low-income housing tax credit. I would guess that in many cases they tend to add value through volunteer labor and some work at below-market wages. Some nonprofits may not receive from government the same reimbursement rates that for-profits do for providing services; they generally have lower overhead recovery and often (according to Clara Miller of the Nonprofit Finance Fund) do not receive full reimbursement for their costs.

Once again, the balancing exercise is worth conducting: In this case, one would want to add government transfers and subtract payments to staff to figure out the net financial transfer to the intended beneficiaries. Then a question for examination is whether the additional value added by the staff (for example, good advice on how to move to a decent neighborhood) is worth the cost.

That a charity may have no private sources of transfers and, hence, no private transfers does not necessarily mean that it is or is not a charity when it is passing through government funds. Essentially, such a hypothetically pure organization with only government and no private transfers is like an arm of government. Its efficiency must be judged relative to the two alternatives: contracts to profit-making entities and direct government provision. Those comparisons require taking into account such provisions as property tax exemption.

### A Final Look at the Objections

In developing this method of testing for the extent of charitability, I have found that objections fall generally into four categories, three stated and one unstated. None, in my view, provide any reason why this method cannot be put into the assessment toolbox for charities. The first objection applies to almost all measures of human activity: They are difficult. For instance, it is hard to measure performance, to report adequately on accomplishments, and to conduct comparability pay studies. Still, charities attempt those measures to whatever degree possible as a way of managing themselves, organizing their thoughts, and refocusing their efforts.

The second objection is that this balancing exercise reveals information along only one dimension of chari-

tability. But so what? Why not test and cross-check (which is what balancing operations allow) along that dimension to the extent possible? After all, most charities make at least some net private transfers. Let's see if their claims of charitability along this dimension stack up when sources are compared with uses.

A third objection is that the tool might be used improperly, not just for internal assessment purposes. The threat that some outside agency or group might use some assessment tool for external accountability review — for example, government could look at a comparability pay study to determine if there are improper payments to some staff that reduce net charitability — hardly justifies throwing the tool away. The importance of any accountability exercise depends on what the charity is being held accountable for. In a charity with a lot of charitable contributions, donors have a right to know how many of their dollars go for intended purposes. By the same token, the IRS should have less concern for the extent of charitability along the transfer dimension when there are no tax dollars at work — that is, when there are no charitable contributions and federal tax exemption is of minimal value.

A final objection is more subtle. Some charities provide negative value added when it comes to what they transfer relative to what they have available to transfer. In effect, as conduits they may actually reduce the net value of transfers made possible by past or current charitable contributions of time and other resources. They may not want to reveal that finding to others or even admit it to themselves.

### Conclusion

Relative to businesses, almost all charities undertake some amount of private transfer, not just of financial assistance but of education, healthcare, information, and creative and promotional endeavors intended for the public good. For such private transfers to individuals or the public to occur, there must be sources. Reconciling sources with uses of charitable transfers offers one very useful way for an organization to perform an assessment of the extent of its charitability. Used judiciously, the method may also be employed for accountability purposes by donors, watchdog groups, or government. In the debate over whether nonprofit hospitals are providing some charitable output beyond what profit-making institutions are offering, for instance, a hospital can be asked to make more explicit not simply what its additional outputs are, but what additional sources of capital, contributions, volunteers, and below-market-wage labor input it has to support those outputs and the value of those sources.