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1 UNDERSTANDING THE NONPROFIT SECTOR AND NONPROFIT ORGANIZATIONS

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LEARNING OBJECTIVES

After reading this chapter, students should be able to

1. Describe the size and scope of the nonprofit sector.
2. Identify characteristics of nonprofit organizations.
3. Summarize various ways of classifying nonprofit organizations.
4. Explain the differences between public charities and private foundations.

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5. Identify various sources of revenue for nonprofit organizations.
6. Explain key nonprofit financial concepts.
7. Summarize major theories that explain the nonprofit sector.
8. Summarize major theories that explain nonprofit organizations.
9. Describe how the environment for the nonprofit sector and organizations is changing.

This book is focused on fundraising. The purpose of fundraising is to secure philanthropic support for nonprofit organizations and institutions. It is an activity unique to the nonprofit sector, and it can be pursued effectively only with a broader understanding of that sector and the organizations that comprise it. This chapter provides an introduction to the nonprofit sector and nonprofit organizations. Those who have completed a course on nonprofit management may wish to skip it, although some may find it at useful refresher and may also find some new points. Portions of this chapter are adapted from another of the author's works (Worth, 2021).

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AMERICA'S NONPROFIT SECTOR: SIZE AND SCOPE

America's nonprofit sector is large, diverse, and complex. It includes an estimated 1.3 million organizations, employing more than 12 million people (National Council of Nonprofits, 2023). They range in size from those that employ hundreds, even thousands of people to others that are managed entirely by volunteers. Their activities touch every aspect of our lives, from nurturing our souls and spirits to educating our minds and protecting our health. The sector and its organizations also are complex. Some nonprofits may not seem like nonprofits at all, and some organizations that sound like nonprofits are not. Indeed, some organizations are hybrids that include for-profit components or that work closely with government. We could experience a good sample of this universe by taking an imaginary walk around the author's home town of Washington, DC, starting out from the author's office on the campus of the George Washington University, located in the neighborhood of Foggy Bottom, near the White House. Some of the organizations we would see are unique to Washington because it is the nation's capital, but a similarly diverse array may be found in any major American city.

Leaving the campus, we might walk a couple of blocks west, passing the George Washington University Hospital, and then head south toward the Vietnam Veterans Memorial. Along the way we would pass Western Presbyterian Church, where we might see people waiting to have breakfast or dinner at Miriam's Kitchen. Although independent of Western Presbyterian, Miriam's is located in the basement of the church and provides food and other services to people

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experiencing homelessness. Taking another turn, we would pass the national headquarters of the American Red Cross and the National Park Service. Continuing on past the Washington Monument and heading up the National Mall toward the Capitol, we would see the buildings of the Smithsonian Institution and, perhaps, catch sight of the National Archives, just a block off the Mall. Depending on our route back to the university, we might walk past the National Geographic Society, the Cato Institute, and the Brookings Institution. Taking a slightly different route, we would see the AFL-CIO, a federation of labor unions, and the U.S. Chamber of Commerce, which represents the interests of the business community. They are located about a block apart from each other, near the White House. Returning to the campus, we would likely need to stop at a Starbucks, since it would have been a long walk and we would be tired! While drinking some coffee, we might reflect on the many sites we have seen and how they represent America's nonprofit sector.

We would surely identify Miriam's Kitchen as a nonprofit; indeed, its mission of serving people who are experiencing homelessness is probably what most people think about when the term *nonprofit* is used. In addition, it is almost totally supported by gifts and a large portion of its workforce is volunteers, both conditions that would fit common perceptions of a nonprofit. We might not think about Western Presbyterian Church as a nonprofit, although it is, and we might assume that the George Washington Hospital is a nonprofit, although it is not. Indeed, the hospital is a for-profit business owned by Universal Health Services, a Fortune 500 corporation, although it is served by doctors from the George Washington University, which is a nonprofit institution. This relationship between a nonprofit and for-profit entity might seem unusual, but we would have seen at least one other example on our walk. The National Geographic Society is a nonprofit organization, but is partial owner of a for-profit business, National Geographic Partners, the majority of which is owned by Disney. The Smithsonian is especially complex. It not only is chartered as a nonprofit institution but is also our national museum and receives substantial government support. In other words, distinctions among the sectors are sometimes difficult to discern.

Most people would readily recognize the American Red Cross as one of the nation's largest nonprofit organizations, although like a government agency, it has a mandate to provide services to the U.S. military and to the nation in times of disaster. The Vietnam Veterans Memorial, the National Mall, and the Washington Monument are, of course, property of the federal government, but all are also beneficiaries of philanthropy. For example, when the Washington Monument was damaged by an earthquake in 2011, the needed repairs cost $15 million. One half of the cost was covered by the federal government and the other half by a gift to the nonprofit Trust for the National Mall from investor David Rubenstein (Heath, 2013).

Finally, we might wonder what to make of the Cato Institute and the Brookings Institution, both nonprofit think tanks that often reflect different perspectives on public policy questions, or the AFL-CIO and the Chamber of Commerce, which often lobby on opposite sides of public policy debates. How can all of these organizations be nonprofits, and what do they have in common? To address that question, let's take a closer look at some of the characteristics that define nonprofit organizations.

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CHARACTERISTICS OF NONPROFITS

As Lester Salamon (1999) explains, all nonprofit organizations have certain characteristics in common. They are **organized entities,** most incorporated under state law, and they are rooted in the **tradition of volunteerism,** even if they have paid staff members. They are private and **self-governing**, with the autonomy to determine how they will pursue revenues, what programs they will operate, and who will benefit from their activities. They may receive government funding in the form of grants or contracts that require them to provide specific services, but they also have the freedom to eschew government funds and operate entirely with revenue from private sources, including fees that they earn from the goods and services they provide (called *earned income*) as well as philanthropy.

Although various terms are used to label the nonprofit sector, including the independent sector, third sector, voluntary sector, and social sector, the term most commonly used—nonprofit sector—really refers to something that such organizations do *not* do. Nonprofit organizations do not distribute their profits; in other words, they face a **nondistribution constraint**. Nonprofit organizations can earn a profit—meaning simply that revenues exceed expenditures—and many do. But that profit must be reinvested in their programs and cannot be used to personally benefit owners or investors. They may pay their employees reasonable compensation for the services they provide, but they may not reward them beyond what those services are worth, as if they were owners of the enterprise. In exchange for these limitations, nonprofits are exempt from taxation by the federal government, a privilege that is also extended with regard to most state taxes.[1] But this exemption applies only to revenue directly related to nonprofits' tax-exempt purposes. To the extent that a nonprofit generates income from business activities not related to its charitable purposes, those revenues could be subject to the **unrelated business income tax (UBIT),** although the overall organization could remain exempt. For example, if a museum operates a parking garage that is used only by staff and visitors, that would be related to its purpose as a museum, and the revenue would not be taxable. But if the museum's garage was open to the general public, the revenue might be considered unrelated and would be taxed; in other words, the Internal Revenue Service (IRS) would consider the museum to be in the parking business, which is not related to the mission of a museum. Nonprofits are careful to clarify the relationship between any earned-income activities and their charitable mission.

Finally, a nonprofit's activities are of **public benefit.** The public benefit is probably obvious when the mission is to feed the hungry, preserve important national treasures, or prevent drug abuse and addiction. But what about organizations that may advocate or even lobby for opposing points of view? In our society, the encouragement of open debate on all sides of an issue is considered to be a public benefit because it advances the policy dialogue essential to democracy. That explains why tax exemption is granted to organizations that advocate competing views, so long as they follow requirements of the law.

A nonprofit's broad purposes are stated in its charter and elaborated on in its mission statement. Nonprofits are **mission-driven.** Mission is the guiding star and the bottom line; it guides planning, major decisions, and standards by which the organization's effectiveness is evaluated. As James Phills (2005) explains,

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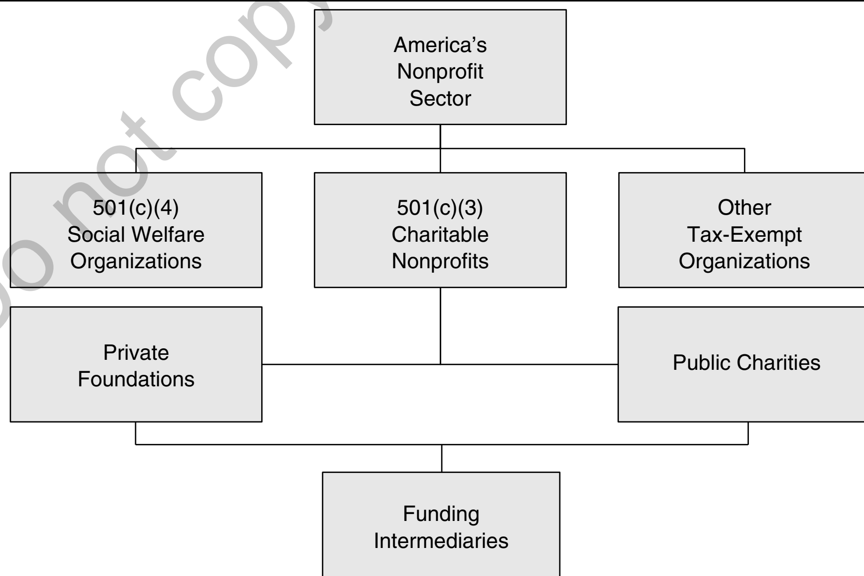
> Mission is the psychological and emotional logic that drives an organization. It is why people get up in the morning and go to work in a nonprofit . . . Mission [defines] the social value that the organization creates. The key feature of social value—whether it is spiritual, moral, societal, aesthetic, intellectual, or environmental—is that it transcends economic value. Thus, it is inextricably linked to fundamental human values, which are the basis for intrinsic worth or importance. (p. 22)

CLASSIFICATIONS OF NONPROFITS

With such a large and diverse nonprofit sector, we need to place organizations into categories that can be more easily analyzed. Various frameworks are used, including the **National Taxonomy of Exempt Entities (NTEE),** which places nonprofits into 26 major groups under 10 broad categories, based on their purpose, activities, and programs. NTEE classifications are similar to industry classification codes used to group for-profit companies. But since our focus here is on fundraising and philanthropy, the classifications most relevant to us—and probably the best known—are those used by the IRS, reflecting the basis for organizations' exemption from the federal corporate income tax.

Figure 1.1 provides an illustration of the nonprofit sector based on IRS classifications. The IRS places nonprofits in 30 different categories, but many are not relevant to our discussion about fundraising, so Figure 1.1 is simplified. It shows the organizations of the most interest to us in this text—charitable nonprofits—in the center. We come back to them—let's look first at the other categories.

FIGURE 1.1 ■ America's Nonprofit Sector



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On the left side of Figure 1.1 are nonprofits exempt from taxation under section 501(c)(4) of the tax code, which the IRS calls **social welfare organizations** but many people call **advocacy organizations.** Two examples are the Sierra Club and the NRA. As the term advocacy suggests, these are organizations that seek to influence public attitudes and advocate positions on public policy issues. They also may engage in lobbying for legislation without any specific limitation.[2] They are themselves exempt from taxation, but a gift to one of them is *not* tax deductible for the donor—that is the trade-off for the right to lobby without limitation.

Some 501(c)(4) organizations work closely with affiliated 501(c)(3) charitable organizations. For example, the Sierra Club is an advocacy organization, but the Sierra Club Foundation is a separate entity that provides education and other programs that qualify as charitable under the tax law. An individual can pay dues to belong to the Sierra Club, which would not be deductible, and also make a gift to the Sierra Club Foundation, which would be. Many professional and industry associations also maintain two related entities, one an advocacy organization and the other a 501(c)(3) that supports educational programs and research. Two related organizations working in this way obviously need to be careful to assure that the activities of each are clearly delineated to comply with the requirements of their respective tax statuses.

On the right side of Figure 1.1 are all other tax-exempt organizations, which are classified under various sections of the Internal Revenue Code (IRC). They include, for example, labor unions, chambers of commerce, and fraternities and sororities, among many others. They are exempt from tax, but gifts to them are generally not deductible. Many play important roles in the nation and in local communities, but again, our emphasis here is on the charitable nonprofits shown in the middle of Figure 1.1.

To be a charitable nonprofit **tax exempt** under section 501(c)3 of the IRC, an organization must meet three tests. First, it must be organized and operated for one or more of eight purposes: charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competitions, and prevention of cruelty to children or animals (Internal Revenue Service [IRS], 2023c). The IRC does not specially mention health, although healthcare institutions are one of the largest components of the nonprofit sector as measured by revenue and employment. It should be noted that religious congregations are charitable nonprofits that are tax exempt under section 501(c)(3). But they are also unique in that they are protected by the constitutional provision of religious freedom. For that reason, they are not required to register with the IRS like other nonprofits, although some do so voluntarily.

Charitable is a broad term, but the IRS (2023e) offers some examples of what is encompassed, including the following:

> relief of the poor, the distressed, or the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening the burdens of government; lessening neighborhood tensions; eliminating prejudice and discrimination; defending human and civil rights secured by law; and combating community deterioration and juvenile delinquency.

In addition to demonstrating that its primary purpose fits into one of these areas, a charitable nonprofit also must meet three additional tests. It must show that it is supported by the public rather than one or a few donors, a point explained further in the next section of this chapter.

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It must meet the nondistribution test, meaning that any profit it earns is not distributed for the personal benefit of any individual. And it must limit its political activities. The latter requires that it not support candidates for public office and that its expenditures on lobbying fall within limits defined by tax law (IRS, 2022). The tradeoff for accepting these limitations and requirements is that charitable nonprofits are both exempt from taxation *and* eligible to receive gifts that are **tax deductible** to donors.

The tax deduction for gifts to charitable organizations is intended to encourage giving and sustain the services that such organizations provide. It should not be viewed as a tax loophole because it is intentionally provided in the law as an incentive to giving. Society has determined that the purposes addressed by nonprofits are to the public's benefit and that if the nonprofits did not exist, those services might need to be provided by government. Being eligible to receive deductible gifts makes it easier for charitable nonprofits to raise funds, since the donors are, at least theoretically, able to give more because of the tax saving realized from the deductions. Federal tax legislation passed in 2017, called the Tax Cuts and Jobs Act of 2017, significantly increased the number of taxpayers eligible to claim a standard deduction on their tax returns. They would no longer be able to receive a deduction based on a list of their specific charitable contributions during the tax year. As a result, fewer people benefit from the deduction of charitable gifts than before that change in the law, although people with very high incomes still qualify for the itemized deduction. Some aspects of the tax law passed in 2017 were scheduled to expire at a future time, and students should check online to see what provision are in effect at the time they are reading this chapter.

The tax deduction provides those who qualify with a significant incentive for giving. For example, suppose a donor is in the 25% tax bracket and makes a $100 gift to a charitable organization. They can deduct that $100 from their income before calculating the tax due. At 25%, that produces a tax saving of $25; in other words, the donor's tax bill will be $25 less than it would have been without the deduction. The effect of the deduction is to reduce the actual out-of-pocket cost of that gift from $100 to $75, since the additional $25 would otherwise have been paid in taxes. Some view the tax savings as a form of subsidy from taxpayers, and some economists refer to the government's loss of revenue as a **tax expenditure.** And since states also provide deductions for charitable gifts, the donor may gain additional tax benefits. Again, it is important to understand that these benefits are not tax loopholes and taking advantage of them is not unethical. Rather, they have been placed in the law intentionally to encourage charitable gifts and the activities they support. Some later chapters of this book return to a more detailed discussion of the implications of tax law for charitable giving where they are most relevant.

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PUBLIC CHARITIES AND PRIVATE FOUNDATIONS

As Figure 1.1 depicts, there are two types of charitable nonprofits—**public charities** and **private foundations**. Both are important to our discussion of fundraising and philanthropy. There are technical definitions of both categories, but it is sufficient to understand that public charities receive funding from multiple sources, including donors and government; that is, they are supported by the public. Most offer programs directly to clients—they are **operating**

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public charities—and they include many of the organizations most of us know best, including universities, hospitals, arts institutions, museums, research institutes, and those that provide human and social services. In contrast, private foundations are funded by one or a few donors, which may include a corporation, an individual, or members of a family. Some of the best-known examples are the Bill & Melinda Gates Foundation, established with gifts from Bill and Melinda French Gates; the Ford Foundation, created by Henry Ford with his personal wealth; and the Walmart Foundation, a corporate foundation created by Walmart. Some foundations do operate their own programs and are known as **operating foundations,** but most are **grantmaking foundations** that provide support to other nonprofit organizations and institutions. Many but not all foundations are intended to exist in perpetuity. The gifts made to create them are invested and only the annual investment earnings are spent to support programs, while the principal remains preserved. Private foundations are discussed in more detail in Chapter 10.

One big difference between public charities and private foundations is that donors who make gifts to public charities can deduct those gifts up to 60% of income, whereas gifts to a private foundation can be deducted only up to 30% of income in a given year. Those limitations were established in the 2017 tax law mentioned earlier and could, of course, change in the future. In addition, private foundations also must pay a modest tax on their investment earnings and are required to spend a minimum of 5% of their assets each year, conditions that do not apply to public charities. For those reasons, public charities are usually careful to assure that they maintain a sufficient base of public support to avoid reclassification as a private foundation.

At the bottom of Figure 1.1 are a group of charitable nonprofits called **funding intermediaries.** These are organizations that receive money from one or more sources and, as the term intermediary implies, then pass that money along to other organizations. Grantmaking private foundations are by definition funding intermediaries, but so are some public charities, which are sometimes called **supporting public charities**. The United Way and Jewish federations are public charities that are funding intermediaries. So are charitable gift funds operated by community foundations and commercial wealth management companies, for example, the Fidelity Charitable Gift Fund. Such funds include donor-advised funds (DAFs), which have shown significant growth in recent decades. DAFs are discussed further later in this text.

It may be confusing that some funding intermediaries that are public charities use the word foundation in their names, although they are not classified as private foundations. For example, **community foundations** are public charities and so are **institutionally related foundations** that raise funds to support a single related entity—for example, the National Park Foundation, which supports the National Park Service, and the University of Florida Foundation, which raises and manages funds for the exclusive benefit of the public institution it serves. The various types of foundations and their characteristics are discussed in more detail in Chapter 10 of this book.

NONPROFIT REVENUE SOURCES

Many people may think nonprofit organizations receive most of or all their revenue from gifts, but indeed, that is far from the case for the sector overall. Sources of revenue vary among the

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various nonprofit subsectors, so we need to dig down a little deeper to understand the full picture. With our focus on fundraising, one of the most important differences is the extent to which different types of organizations depend on philanthropy.

The largest source of revenue for the nonprofit sector overall is fees for services and goods paid by clients or customers, accounting for 50%. This includes, for example, tuition paid by students, tickets purchased by concertgoers, and hospital bills paid by private individuals or their private insurance companies. Another 23% of revenue comes from fees for services and goods paid to nonprofits by government, for example, payments Medicare and Medicaid make to hospitals to cover medical care for people they insure. These government payments are distinct from government grants, which often have restrictions on their use but are not payment for specific services or goods. Government grants account for another 9% of nonprofit sector revenue. Looking at the charitable nonprofit sector overall, gifts account for only 13% of total revenue, but this percentage is greatly affected by the inclusion of hospitals and universities, which—as students will readily understand—generate substantial revenues from fees for service (Candid, 2023).

Having an understanding of how an organization generates its revenue is important for individuals who are engaged in fundraising for that organization. Whether philanthropy is a major or minor component of the organization's overall revenue will influence the effort and resources devoted to fundraising. At a practical level, there may be differences in the roles that fundraising professionals play in various organizations, as well as their compensation, depending on how important gift support may be to the organization's overall financing. This chapter returns to a further discussion of these important points at a later point.

NONPROFIT FINANCIAL CONCEPTS

The subject of nonprofit financial management is a large one, beyond the scope of this text. But a basic understanding of a few terms is essential and will be important to have later in the text when we discuss different types of gifts and how they must be managed.

Nonprofit finances are different from those of individuals and for-profit businesses. For one thing, a nonprofit receives gifts and grants, some of which have been designated by the donor to be used for a specific purpose. This requires that a nonprofit maintain a variety of funds, each subject to different conditions.

A nonprofit's **operating funds** are much like those each of us manages in our checking accounts. In general, payments received are intended to be spent within the same period to pay current bills. A nonprofit's operating funds may be **unrestricted** or **restricted.** Fees nonprofits receive for services provided to customers or clients and gifts from donors who do not designate a specific use are generally unrestricted, which means they may be used to meet any expense. Nonprofits also receive payments that are restricted to particular purposes, and they are required to ensure that they are spent accordingly. For example, a donor might make a grant to a school and specify that it be used to purchase art supplies; the school would not be able to use it for sports equipment. The flexibility that comes with unrestricted gifts makes them highly valued by nonprofit organizations. However, many donors, especially when larger gifts are involved, prefer to place some restrictions on their use. The organization has a legal

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obligation to comply with such restrictions, and, of course, doing so may be essential to receiving further support from the donor.

Funds may be **temporarily restricted** or **permanently restricted.** Funds that are temporarily restricted might result from an advance payment on a gift or grant to cover some activity that has not yet occurred. In the earlier example, the grant to purchase art supplies is temporarily restricted until the supplies are purchased. As the term implies, funds that are permanently restricted can never be used for anything other than the intended purpose. That would be the case with most **endowment funds** created by donors. The investment income that endowment funds generate may be unrestricted or restricted, depending on the stipulations of the donor, but if the donor directs that principal be preserved in perpetuity, then the organization can never expend it. Some donors may direct that principal remain invested for a term of years, after which it may be expended; funds resulting from such an arrangement are called **term endowments**.

There are two basic categories of endowment funds that an organization might hold: **board-designated endowment** (also called **quasi-endowment**) and **permanent endowment** (also called **pure endowment**). As the term suggests, a board-designated endowment includes funds that the organization's board has decided to invest for the long term, using only the investment earnings. For example, the organization may have accumulated reserves that exceed what it really needs to have; the board may decide that those funds should be invested, to enhance long-term stability. Since it was the board's decision to place the funds in the endowment, the board has the authority to withdraw the funds from the endowment if it determines that to be necessary or desirable. But a board would be reluctant to draw down quasi-endowment funds except in relatively dire circumstances.

With a permanent or pure endowment, the board has limited or no flexibility. The board does not have the legal authority to invade the original principal of the gift or to use the income for purposes not consistent with the donor's direction without first obtaining the donor's approval or, with strong justification, permission from a court of law.

It may be a common perception that endowment is an asset held only by relatively few major institutions, such as universities, foundations, and museums. Those types of organizations do have the largest endowments, but recent years have seen efforts to raise endowment funds by a larger and more diverse group of organizations. Some of them view endowment as a way to develop a stream of revenue that might offset fluctuations in other sources over the long term.

One additional principle of nonprofit accounting is especially relevant to our focus on fundraising, the distinction between the **cash basis** of accounting and the **accrual basis** of accounting. Using the cash basis, financial transactions are recorded only when money changes hands, that is, when a payment is received or a bill is paid. But that may present a misleading picture of the actual financial situation, since it does not reflect **accounts payable,** that is, obligations the organization has undertaken but not yet fulfilled, or **accounts receivable,** for example, **pledges**—promises to give that donors have made.

Pledges are counted as revenue when a donor has signed a written commitment. In that case, the transaction would not be recorded as revenue when the pledge is paid—that would be double counting—although there are accounting entries that are made to reflect the change in circumstances. So signed pledges are revenue, although the funds are not available to the

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organization until the pledge is paid. As discussed later in this text, it is not uncommon for an organization to complete a successful fundraising campaign, having reached its goal but without much cash on hand as a result. Pledges will have been recorded as revenue, but it may be years before the organization has the cash.

EXPLAINING THE NONPROFIT SECTOR

Now that we have an understanding of the types of organizations that comprise the nonprofit sector, sources of nonprofit revenue, and some key principles of nonprofit financial management, there remains a fundamental question: Why does this sector exist? Theories that address this question have been proposed by economists, sociologists, historians, political scientists, psychologists, social psychologists, anthropologists, and scholars in other disciplines.

Historians explain the existence of the nonprofit sector in terms of historical forces and events. They describe the nation's early tradition of voluntary action and the role of urbanization, industrialization, and immigration in shaping society and creating the need for the services nonprofits provide. The freedoms of speech, religion, assembly, and petition, enshrined in the First Amendment to the U.S. Constitution, have provided a hospitable environment, especially for organizations seeking social change. For example, the civil rights, women's rights, and LGBTQ+ rights movements, all were advanced by nonprofit organizations. The advocacy of nonprofits focused public attention on injustices and helped create changes in social attitudes that paved the way for legislative action. Nonprofits also have taken the lead in raising awareness about climate change, which is now receiving attention from governments and international agencies around the world. *Sociologists* study relationships between and among people in groups and explain how nonprofits help socialize individuals, reinforce common norms and values, build social capital, and provide mediating structures between individuals and large organizations in the governmental and business sectors. Political scientists look at the role of nonprofits in supporting democratic traditions and how they affect power relationships within society. They describe how nonprofits accommodate diversity, undertake social experimentation, provide freedom from bureaucracy, and address minority needs. All the social science disciplines have added important perspectives on nonprofit organizations and the nonprofit sector. But economists have developed the best-known theories to explain the sector, although those theories are sometimes controversial (Ott & Dicke, 2021).

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Failure Theories

One set of influential theories advanced by economists to explain the existence of the nonprofit sector is called **failure theories**. Economists analyze the world in terms of exchanges that occur in markets. People give up something, usually money, and get something in return. Economists use the term goods to mean everything that comes in return, including services or even intangible benefits, like psychological peace or warm feelings.

Through the forces of supply and demand, markets are effective in determining the production and consumption of what are called **private goods,** that is, goods we consume

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as individuals without any positive or negative effect on others. So for example, the clothing we wear, the food we eat, and haircuts we receive are private goods; we capture the full benefit of using them with little, if any, impact on others. If we buy them, they will be provided, and if we don't, they will cease to be produced; the market is a relatively effective mechanism for determining how society's resources are allocated to the production of private goods.

But some goods have **externalities.** In other words, your consumption of them affects others, either negatively or positively. To use a positive example, if you were personally to hire a contractor to pave your street, that would provide you with the benefit of a smoother ride, but your neighbors also would enjoy that ride at no cost to them. In this example, they would be what are called **free riders,** who enjoy the positive externalities you have created but cannot capture entirely for yourself. There is no way you could prevent neighbors from gaining this benefit at your expense, so you probably would be disinclined to pay for paving of the street alone. For goods like this, the market does not do a very good job of allocating resources, so we define them as **public goods,** assigning their production to government and paying for them through our taxes.[3] We all benefit, and we all pay for public goods, like fire and police protection, military defense, and for the most part, paved roads. Giving is unlike a commercial exchange because the benefits created may go to people other than those who paid. Those who benefit may be, in the context of failure theories, like free riders, but the benefits they receive are, indeed, intended by the donors. That intention distinguishes a gift from a purchase and perhaps fundraising from marketing, a topic discussed further in Chapter 2.

But let's get back to the question at hand: Why is there a nonprofit sector? In part, because of **market failure** (Hansmann, 1987). Markets are inherently ineffective in providing public goods because of the free rider problem. But government may fail as well—there may be **government failure** (Weisbrod, 1975, 1988). This does not mean that government is necessarily inept but rather that it may be constrained in what it can do. For example, there may not be political support for addressing the needs of minority groups or consensus about the best way to address emerging problems like climate change. The solution to a problem may not be clear, and it would simply be too risky for government to commit public funds to an untested strategy. Or government may be too large and too bureaucratic to fully recognize and respond to local needs. In cases where neither the market nor government can provide a needed good, economists theorize, nonprofits step in to fill the gap. Sometimes they do this by providing goods directly, and at other times they mobilize public opinion and build consensus until government is able to act. It is important to note that economists also identify a third failure—voluntary failure—which may occur if nonprofits are simply unable to obtain the resources necessary to meet the need (Anheier, 2014, p. 201).

Although failure theories have gained wide acceptance, some economists offer a different approach to explaining the nonprofit sector. Various **supply-side theories** attribute the existence of the nonprofit sector to the initiatives of individuals who have created organizations, often motivated by religious faith or social conscience rather than any economic incentives (Rose-Ackerman, 1996). Thus, theories of social entrepreneurship and altruism offer a counterpoint to the failure theories. Theories related to altruistic behavior predate the nonprofit theories of economists and continue to be a focus of scholars. They are drawn from the work of

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philosophers, theologians, and legal scholars as well as psychologists, social psychologists, and other social scientists. Marilyn Fischer (2000, pp. 10–12) calls the nonprofit sector the "gift economy" because it is often supported through voluntary gifts, and donors do not receive a quid pro quo, as they do when they purchase a product in the marketplace. Rather, the benefit of their gift payment goes to others, who are served by the organization's programs. But theorists who focus on charitable and philanthropic giving raise the following questions: Do people really make gifts based on altruism, or is giving a social exchange, in which the donor receives benefits that include warm feelings and recognition? And what influence do tax benefits play in the motivation of individuals to make gifts? In other words, is charitable and philanthropic giving always motivated by ideals, or do donors also expect to receive some benefits for themselves? This text returns to the subject of donor motivations in a subsequent chapter, which explores some of these questions.

An Interdisciplinary Approach

In his 1992 book *The Commons*, sociologist Roger Lohmann introduced the **theory of the commons,** which differed from the failure theories. Lohmann's (1992) theory has been challenged by many scholars, particularly economists, whose theories he rejects. Indeed, he has offered concessions, clarifications, and modifications in subsequent writings (e.g., Lohmann, 2015). However, Lohmann's ideas offer some useful insights that relate to giving.

According to Roger Lohmann (1992), the commons are "an economic, political, and social space outside the market, households, and state in which associative communities create and reproduce social worlds" (p. 59). Rejecting the dichotomy of public and private goods, Lohmann defines a third kind of good—**common goods**. As he explains,

> One of the most powerful criticisms of the application of the public goods orientation to nonprofit or voluntary action is that most commons fail to fit the description of a public good. [For example,] church services, lodge meetings, food pantries, scientific meetings, amateur athletic events, and most other commons are available to some people (members and participants) without being available to all. Thus, they fail to meet the criterion of indivisibility, which is one of two defining characteristics of public goods . . . Yet many of the desired or preferred ends or objectives of common action are clearly not private goods either. They cannot be fully alienated and controlled exclusively by particular individuals without ceasing to be what they are. There is an undeniably other-oriented quality to any religious ritual, scientific finding, or artistic expression, for example. (p. 171)

Thus, whereas private goods benefit only the individual who consumes them and public goods benefit everyone, common goods are of benefit to (or of interest to) only the members of a particular commons. Lohmann (1992) acknowledges that failure theories may explain nonprofits that derive much of their revenue from earned income, for example, "through ticket sales or fees charged for services, such as orchestras, opera companies, hospitals, nursing homes, and various types of social service agencies." But, he argues, "[c]ontemporary economists have largely ignored large portions of the commons" (p. 175).

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What Lohmann adds to understanding of fundraising and philanthropy is insight on the behavior of donors. One person may make a gift to the annual fund of their alma mater, but probably not to a university they never attended. One person may support research to find a cure for a disease that afflicts members of their family, but another person may support research related to a different disease that afflicts their family more. Some people may make a gift to improve a park near their home, but perhaps not for one located in a different community. In other words, for any organization, not every person is a realistic prospective donor. Only members of a particular commons are. This book expands on this point more fully in a later chapter that discusses identifying prospective donors for a particular purpose or organization.

EXPLAINING NONPROFIT ORGANIZATIONS

Now that we have examined some macro theories that explain the nonprofit sector, let's turn to some micro theories, that is, theories that explain the behavior of individual nonprofit organizations. The field of organizational theory is large, and recent years have produced a considerable body of work specifically addressing the distinctive features of nonprofit organizations. Thus, our discussion must be selective and focus on a few theories that have particular relevance for fundraising and philanthropy.

Nonprofits as Systems

One of the early organizational theorists, Max Weber, who wrote in the early 20th century, defined the concept of the **bureaucracy** as an ideal model for an organization. To Weber, bureaucracies characterized by formal hierarchy and rules could become machinelike in their efficiency and effectiveness. It was a model that seemed to fit well with the emerging industrial age in which Weber wrote, and it may still describe how many people think about organizations today, especially large ones. Weber's view of organizations as machines—and people as cogs—eventually was overtaken by theorists of the "human relations school," who emphasized human needs, motivations, and incentives in the workplace (Rainey et al., 2021, p. 29). But these theories addressed the internal dynamics of organizations and the behavior of individuals within them and did not consider how organizations might interact with or adapt to the environment around them.

Thinking shifted during the 1960s, when theorists began to look at organizations as **systems** and analyze how they interact with and adapt to the external environment that surrounds them. A landmark book by Daniel Katz and Robert Kahn published in 1966, *The Social Psychology of Organizations*, introduced the concept of organizations as **open systems,** and their work has influenced the thinking and writing of numerous other scholars since. Because systems theory describes how a nonprofit organization interacts with and adapts to its environment, it provides a fundamental framework for understanding fundraising and an organization's relationships with donors.

A simple system is one that receives inputs, processes those inputs in some way, and produces outputs. It also receives feedback from its environment and is able to adapt in light of

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the information it receives, that is, to learn. For that reason, systems theorists see organizations more like living organisms than machines, always evolving to survive in a constantly changing environment around them.

Organizations may be **closed systems** or open systems, although most are on a continuum between those two extremes. A closed system is one that is relatively self-sufficient and does not need to respond much or at all to influences from the external environment. It is difficult to think of an organization that is totally closed, but some governmental agencies that provide essential services may be somewhat so, since they are likely to receive sufficient appropriations and have relative autonomy in determining their own policies and procedures. Some nonprofit institutions that have large endowments may be relatively closed. If they are able to mostly operate on their investment earnings and are not overly reliant on client payments or gifts, they may be relatively free to chart their own courses without paying too much attention to outside pressures. Some people argue that some foundations demonstrate these qualities, and as a result, their grantmaking is often less responsive to society's needs than it should be.

Most nonprofit organizations are relatively open systems. They have missions defined in terms of social benefit. They are reliant on financial support that comes from outside, either from donors, clients, or government. They are chartered and regulated by government, and their tax exemption is viewed as a public subsidy. Because they enjoy tax benefits and serve public purposes, they are often the subject of scrutiny from charity watchdogs and the media. With these characteristics, it would be difficult for them to remain totally closed, oblivious to the circumstances and pressures of the world around them.

In addition, many organizations rely on volunteers at various levels. In some nonprofits, volunteers—called **service volunteers**—directly provide its programs, for example, tutoring children or providing food to victims of a disaster. In most nonprofits, the governing board is comprised of volunteers, some of whom may also be service volunteers. Of course, volunteers choose to be associated with a nonprofit organization; they receive no tangible compensation. They are free to come or go as they may prefer and also to hold and express opinions. Some of them may also be donors, and some of them may serve on the governing board. Information and opinion often flow freely up, down, and around the organization, crossing the boundaries that define it.

Boundary-Spanning Roles

In an open-systems environment, the boundaries between what is *inside* and what is *outside* are often permeable. That makes the role of **boundary spanners**—who provide linkages between internal and external—especially important (Grønbjerg, 1993). Nonprofit CEOs and other staff members may sometimes function in a boundary-spanning role, for example, when they are involved in fundraising or advocacy. But much of their work also may be confined to internal matters, including the management of budgets, staff, and programs. On the other hand, the organization's governing board and fundraising professionals generally will have little responsibility for day-to-day management of the organization's programs. They are, by definition and design, the organization's principal boundary spanners.

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Governing Boards as Boundary Spanners

Members of the governing board of a nonprofit include individuals drawn from the organization's community, however that community may be defined, depending on the nature and scale of activities. In organizations that have members, boards are often elected by the membership. In other organizations, the board may be self-perpetuating; new members are elected by the current members of the board. Some boards may have members who are appointed by another organization, for example, a sponsoring religious congregation. And some nonprofits have hybrid boards, with members chosen through a combination of these methods.

Sometimes the organization's CEO serves as a member of the governing board, other times not. But most board members are donors, clients or former clients, local community leaders, business leaders, and members of other groups. Most are unlikely to have the same professional expertise of individuals on the nonprofit's staff. For example, an organization offering services to children may have a CEO who is a trained social worker or psychologist and knows more about the needs of young children than most people serving on the board who have only their personal experiences to inform their views. But it would not be desirable or appropriate to simply defer to the professional judgment of the CEO in all matters concerning management of the organization and its programs. The organization's mission is to address needs of its community, and it is supported by that community. Since it is tax exempt, it receives a public subsidy for providing service to the community. The community thus has a stake in how it manages its resources and what activities it undertakes. So one of the governing board's responsibilities is to act as a watchdog, representing the interests of the community and assuring that the CEO and other staff members act in its interests. It is the board's responsibility to assure that the nonprofit's resources are properly applied, that its programs are aligned with community needs, and that it is accountable for accomplishing the purposes for which it has been chartered. Indeed, the governing board has fiduciary responsibilities that are defined in law.

In a landmark case in 1974 (formally *Stern v. Lucy Webb Hayes National Training School for Deaconesses and Missionaries* but generally known simply as the Sibley Hospital case), the judge articulated the legal responsibilities of nonprofit boards as the duties of **care, loyalty,** and **obedience.** In simplest terms, care means that board members must pay sufficient attention and monitor the organization's finances and management. Loyalty requires that they put the organization's interest ahead of their own and avoid conflicts of interest. And obedience requires the board to assure that the organization follows both the law and the dictates of its charitable mission. In extreme cases, board members can even be held personally liable for improper actions by the nonprofit as a result of their failure to meet these responsibilities.

But the board's responsibilities run in two directions. It not only is responsible to society for what the organization does, but it also has a responsibility to sustain and protect the organization itself. Since board members are often leaders in the community and have particular credibility in their respective fields, they may be the organization's best advocates and champions in the outside world. And, although many governance scholars give only fleeting, if any, attention to the board's fundraising role, others see it as central to the its larger fiduciary responsibility. For example, M. Gasby Brown (2022) writes, "Members of the nonprofit's board of directors should be the organization's first donors and first fundraisers" (p. 229). In summary, the

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governing board sits at the doorway between inside and outside, with dual responsibilities; in other words, the board plays a boundary-spanning role.

Fundraising Professionals as Boundary Spanners

Fundraising professionals are also boundary spanners. They represent their organizations to donors and may be effective to the extent that they understand and can communicate their organization's mission, values, programs, and priorities. But they also communicate and interpret the attitudes of donors to those inside the organization, including the CEO and program staff. Thus, although they are employed by and compensated by their organizations, fundraisers also have responsibilities that run in two directions. That can be a complex role when there may be some disconnect between the priorities of the organization and those valued by its donors and other constituents. And fundraising professionals usually do not have the power to shape the organization's programs and priorities, which are determined by the governing board and program staff.

Resource Dependence

Building on open-system theory, Pfeffer and Salancik's (1978) **resource dependence theory** explains how the behavior of nonprofits is influenced by their dependence on external constituencies for financial and other resources. How and from where an organization derives its revenues influences not only its behavior in the external world but also much of what goes on internally, including what goals are established, how performance is measured, the relative position and influence of various groups, and the intangible but important quality of culture.

Resource Dependence and Autonomy

A fundamental assumption of resource dependence theory is that nonprofit organizations seek to manage their resource dependencies to maximize autonomy, the ability to determine their own goals and activities. One way they do that is by striving to achieve a diverse mix of revenue sources. If the organization is dependent on one or a few sources of revenue, there is the risk of **goal displacement,** whereby the nonprofit alters its goals and programs to fit the demands and desires—explicit or implicit—of its funding source. Or an organization might take on new programs simply because there is funding available, even if those programs are marginally related to its mission. Over time, chasing the money could lead an organization far away from its original purposes, something referred to as **mission drift.** An organization's mission is not immutable, and nonprofits often revise their mission statements as needs evolve. A conscious and deliberate change in mission could be consistent with keeping the organization relevant and effective. But a gradual and unconsidered evolution in the mission that occurs in response to funding opportunities or constraints could result in an organization that becomes unfocused and ineffective.

Resource Dependence and Internal Power

How an organization obtains its resources affects which groups hold power within it. As Pfeffer (2003) explains, "The people, groups, or departments inside organizations that . . . manage important environmental dependencies, and help the organization obtain resources, [hold]

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more power as a result of their critical role" (p. xiii). Thus, for example, in an organization that relies on gift support, fundraising professionals likely will hold important positions and their departments will be well funded. In an organization that receives most of its revenue from government, fundraisers may be less central; those who manage supported programs and maintain the accounting and reporting systems required to comply with government regulations will be among the most important people in the organization. In a nonprofit that has substantial earned income, those who produce and market its products may hold significant internal power. For example, in many trade and professional associations, the membership office is responsible for most of the revenue, which comes from dues and other fees members pay. Philanthropy is often a small component of revenue. In this environment, fundraisers may find their efforts constrained by the membership office's concern that gift solicitations could negatively affect membership totals.

Efforts to diversify funding will inevitably confront established structures and power relationships within the organization. Let's consider the scenarios represented by three hypothetical organizations that need to consider ways to increase revenue from philanthropy and are also concerned about autonomy and the possible consequences of a changed revenue mix. Internal power relationships play a role in addressing these decisions.

The first is a nonprofit research institution that historically has relied almost entirely on grants from government agencies to support its work. The directors of its major research programs now are urging the CEO to diversify funding sources to sustain the work of their departments. These directors are the most powerful group within the organization, since they generate almost all the grants that support the work of their departments. And they are reporting a more challenging funding environment. Foundations and government are cutting back, and the research directors are urging the CEO to explore gifts from individual donors as a way to prepare for a more uncertain future. Autonomy also is limited in the existing scenario. As the CEO explains, "All of the research we do is driven by the interests of our funders," adding, "It would be desirable if our scholars had more flexibility to explore some topics of their own choosing, and indeed, our program directors are concerned about retaining our most creative staff members in our current model."

But there are internal obstacles to the transition the directors are advocating. Historically, the development office has been small and lacks the infrastructure of an effective fundraising operation. Most proposals for research grants have been written by the research staff, and the director of development has been positioned far down in the organizational chart, without easy access to the CEO. Given the organization's principal source of revenue, it is not surprising that the chief fundraising officer has not been a major player, but it is difficult to see how the organization can quickly pivot to relying more on fundraising success.

Another organization is also a research institution, with some similarities to the first but with a different revenue profile. It was fortunate to have a substantial endowment, which has supported much of its operation throughout most of its history. This has permitted great autonomy, and the researchers employed at the institution historically have been free to pursue projects of their own design. But the endowment has fluctuated during various economic and market cycles and the board and CEO see a need to develop more philanthropy to support the

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institution's long-term viability and growth. The program directors were assembled to consider the CEO's views, and the reception was not entirely positive. The directors were perceptive in recognizing that more philanthropic support, from corporations, foundations, and individuals, might result in diminished autonomy. Indeed, the program directors expressed concern that donors or sponsors might try to influence the outcomes of their research or perhaps influence their priorities in more subtle ways, through their willingness to fund certain projects over others. Their preferred remedies to financial concerns are for the CFO to do a better job of investing the endowment and for the CEO to obtain major gifts from donors who would place no restriction on their use, perhaps an unrealistic expectation. In this situation, the CEO faces significant internal challenges in steering the organization in a new direction.

A third organization is primarily dependent on earned income and received very little philanthropy. It undertakes research and also produces educational materials that are sold for a fee. In addition, the organization maintains various marketing partnerships with corporations that sponsor some of its work. Concerned about the vicissitudes of the marketplace, the CEO is interested in the possibility that revenue sources might be diversified through philanthropy.

Although it is a nonprofit, this organization operates much like a business, and indeed, the most influential person in the organization after the CEO holds a title similar to "director of sales and marketing." There is no director of development, and the director of sales and marketing, perhaps with some implicit understanding of how resource dependence theory might work, is reluctant to see such a position created. They argue that it would take resources away from their budget for marketing and that the amount of gift revenue that might be raised would be more than offset by declining sales of products. The solution, they propose, is not to undertake fundraising but to expand the inventory of products and enhance the marketing budget.

The situations these three organizations face all exhibit the interplay of external and internal conditions. The first seeks to diversify its sources of revenue to gain financial stability and to expand its autonomy. It is being driven to do so by important internal stakeholders, the research directors. But it has little internal capability for building a fundraising program, due to its historic dependence on government grants. The second organization has been a relatively closed system, supported by its endowment. Its board and CEO see a need to increase philanthropic support, but some of its most important internal stakeholders have concerns about the reduction in autonomy that becoming a more open system might entail. The third is an open system; it is quite responsive to its customers and corporate sponsors. But it has a commercial market culture that may work against the long-term perspective essential to increasing philanthropic support. In each case, the challenges faced in attempting to diversify revenue sources, by increasing philanthropy, are related to the organization's history, current revenue model, and the push-and-pull of internal forces.

While all three are examples of organizations looking to increase philanthropy, similar tensions may arise in organizations that wish to diversify revenues in other ways. For example, a nonprofit that is mostly supported by gifts may be reluctant to accept the limitations and regulations that come with the acceptance of government funds. And those that are primarily supported by government may not have the capacity or culture to undertake new earned-income ventures. Such organizations may have cultures that value accountability and compliance more

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than innovation or risk taking, which also may not be highly valued in the cultures of organizations that have substantial endowments. Those dependent on earned income or corporate partnerships may exhibit cultures similar to business firms, and those that rely on individual donors may have a more voluntary culture.

Resource Dependence and Organizational Skills

An organization's revenue model dictates what skills it must possess or obtain. Collins (2005) defines four revenue models (which he calls "economic engines"), defined by the extent to which organizations are dependent on business (earned) income and on gifts and grants from private sources. Collins suggests that there may be similarities among organizations in any single quadrant, even though their missions and programs may be quite different. Thinking back on our discussion of resource dependence theory, similarities may include the skills that are most valued, which staff experts hold internal power, and the intangible but important element of culture.

As shown in Figure 1.2, organizations in Quadrant I have little gift support or earned income. They are primarily dependent on government funds. They include some nonprofits that provide human and social services and that derive most of their revenue from government grants and contracts. Managers of these organizations must possess political skills and the ability to maintain support among the public, whose attitudes will, of course, influence government decision makers. There would not be much of a role for a fundraising professional in such an organization.

Organizations in Quadrant II rely substantially on gifts from individuals and have little business income. They require managers who are effective fundraisers and who can maintain personal relationships with donors. They include, for example, many national charities that raise funds to support research on specific diseases.

Quadrant III organizations generate substantial earned income and also receive substantial philanthropic support; they require both business acumen and fundraising skills. They include many performing arts centers, independent educational institutions, and even some national nonprofits (for example, Goodwill and the Girl Scouts) that rely on both types of income. Fundraising professionals employed in such organizations have important roles, but staff members who support the earned-income activities do as well.

Finally, organizations in Quadrant IV may receive private gifts and grants, but earned income is their principal source of support. They may operate much like businesses and may value business skills above others. Fundraisers employed in these settings may find that their efforts account for a relatively small portion of total revenue and that their role within the organization is commensurate. This quadrant may include some educational and healthcare institutions, which receive gifts but rely more on charges for the services they provide.

As the four quadrants in Figure 1.2 suggest, and as the three examples of research institutions discussed earlier illustrate, the challenges of developing additional philanthropic revenue are more complex than simply adding money to the fundraising budget and sending out more emails requesting gifts. As discussed further in a subsequent chapter of this text, fundraising is not an activity that can be successfully confined to the periphery of the organization; it cannot

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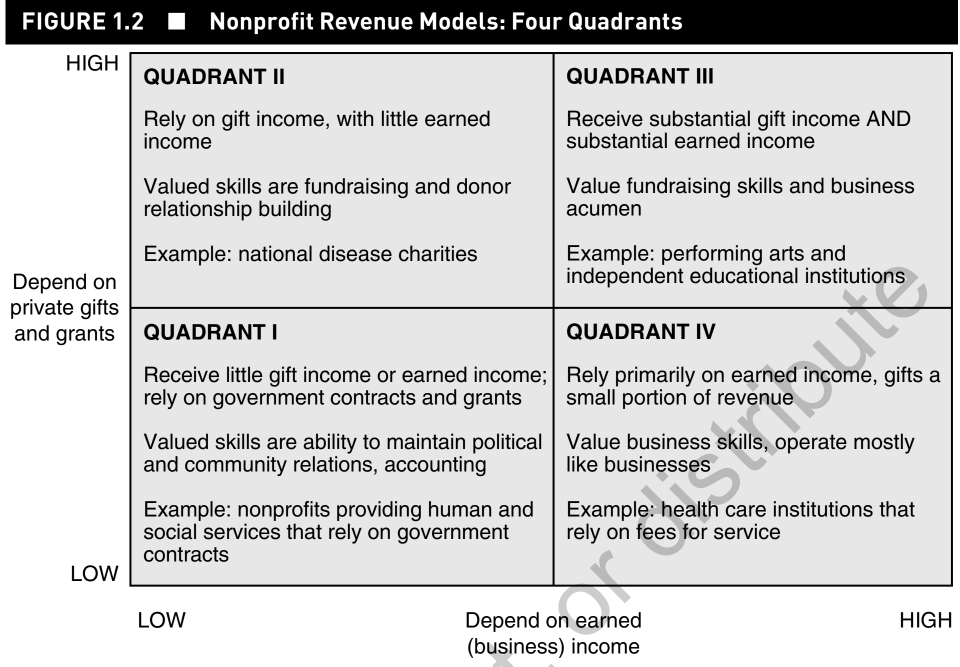
FIGURE 1.2 ■ Nonprofit Revenue Models: Four Quadrants



Source: Adapted from Collins, J. C. (2005). *Good to great and the social sectors: A monograph to accompany Good to Great* (p. 21).

be a mere appendage that generates revenue without shaping the organization in more substantial ways. Enhancing fundraising requires that managers of the organization develop new skills or hire people who possess them. Fundraising must be based on mission and vision, which may need to be refocused to be a better fit with the priorities of donors. The organization may need to become more open and consider the inevitable trade-offs between autonomy and external support. Long-established revenue dependencies will have influenced the organization's structure, its internal distribution of power, and its culture, all of which may be deeply entrenched and altered in a different revenue model. An organization that seeks to increase philanthropy thus may need to accept fundamental and potentially disruptive change as the price for expanding its financial resources.

A CHANGING ENVIRONMENT

The world has changed in significant ways in recent years and the nonprofit sector has been significantly impacted. The COVID-19 pandemic that shut down much of the United States in 2020, and the economic recession that accompanied it, was a significant event for the entire sector. During the pandemic, many organizations suffered losses in revenue and needed to reduce employment, even as the demand for many services was increased. But the impact was uneven. In the early days of the pandemic, organizations depending on fees for service,

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such as the arts, suffered notable declines in revenue, while others benefitted from an overall increase in giving by individuals and corporations (Independent Sector, 2021). Many organizations demonstrated resiliency in their responses; however, pandemic-related economic changes, including increased costs, presented an existential challenge to others (Swensen, 2022). Long-term changes resulting from the pandemic will need to be observed over time, but trends that were accelerated by the pandemic—including remote work and the increasing use of virtual communication—surely will have lasting impact on the nonprofit sector and on fundraising practice.

A movement that began before the COVID-19 pandemic but that gained momentum during that period is known as **mutual aid** (Lynch, 2021). In simplest terms, the movement includes groups of individuals who provide support to each other informally. Some networks are supported by formal organizations but others operate without any infrastructure. Lynch (2021) describes mutual aid as the "hidden nonprofit sector," and its impact on society and traditional organizations will need to be evaluated over coming years.

In addition to the COVID-19 pandemic, 2020 was marked by the murder of George Floyd. There also was a realization that the pandemic disproportionately affected communities of color. These realities led to an intensified national dialog regarding social justice, with significant implications for nonprofits in all fields. Many adopted statements reaffirming their commitment to diversity, equity, and inclusion and even modified their mission statements to reflect their increased focus on social justice (National Council of Nonprofits, 2022). This heightened awareness concerning social justice, changing demographics of the nation's population and of donor communities, and concerns about the relative absence of diversity in the fundraising profession have influenced discussions of fundraising and philanthropy and will continue to be influential in the years ahead.

CHAPTER SUMMARY

America's nonprofit sector is large, diverse, and complex, including 1.3 million organizations, employing more than 12 million people (National Council of Nonprofits, 2023). Nonprofit organizations are organized entities, rooted in a tradition of volunteerism, that are private and self-governing and pursue purposes that are of public benefit. They are mission-driven and face a nondistribution constraint, meaning that they cannot distribute profits to owners. They are exempt from the federal corporate income tax and most state taxes.

Nonprofit organizations are classified according to the National Taxonomy of Exempt Entities (NTEE) and by the Internal Revenue Code. The latter includes many different classifications, including social welfare organizations, exempt under section 501(c)(4), and charitable nonprofits, which are exempt under section 501(c)(3). Both are tax exempt as organizations, but only the latter can receive gifts that are tax deductible to the donor. For that reason, the latter are most relevant to this book's focus on fundraising and philanthropy.

There are two types of charitable nonprofits: private foundations and public charities. Public charities include the best-known nonprofit organizations that provide direct services. Most private foundations are funding intermediaries—they receive funds from individuals or

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corporations and then distribute them as grants to operating nonprofits. Some public charities are also funding intermediaries, including for example, United Way.

The largest source of revenue for the nonprofit sector overall is fees for services and goods paid by clients or customers, accounting for 50%. Another 23% of revenue comes from fees for services and goods paid to nonprofits by government. Government grants account for another 9% of nonprofit sector revenue. Looking at the charitable nonprofit sector overall, gifts account for only 13% of total revenue (Candid, 2023).

Nonprofit financial management includes some unique concepts. Operating funds may be unrestricted, but some are restricted to purposes identified by donors or grantors. Funds may be temporarily restricted, until the purpose has been fulfilled, or permanently restricted. The latter include endowment funds, most of which are required to be invested in perpetuity with only investment earnings available to support programs.

Theories to explain the existence of the nonprofit sector have been developed in various social sciences. Among the best known are the failure theories of economists, which explain nonprofits in terms of filling gaps left by the market and government. Some economists also have developed supply-side theories based on the initiatives of nonprofit founders (Rose-Ackerman, 1996). Lohmann's (1992) theory of the commons explains nonprofits as providers of common goods, which are of interest to particular groups of people who support those organizations.

Most nonprofit organizations are open systems, which interact with the environment around them. Because nonprofits obtain funds and other resources from the external community and have voluntary cultures, the boundary between inside and outside is often permeable. That makes boundary-spanning roles important. Such roles are played by the governing board and fundraising professionals. The board has a legal fiduciary responsibility to both monitor the organization and serve as its protector and advocate. Both board members and fundraising professionals must look inward as well as outward at the same time to meet their dual responsibilities.

Resource dependence theory describes how nonprofits' sources of revenue may affect their autonomy and also influence internal features, including power relationships and the skills required to manage. One risk is that donor requirements or preferences will result in goal displacement. Nonprofits try to maintain autonomy by diversifying revenue sources.

Internal power is held by positions responsible for generating the organization's revenue, and a change in the revenue model will have an impact on internal structure and relationships, which may be disruptive. Nonprofits with similar revenue models may demonstrate similar characteristics, including cultures, even though their missions and programs are quite different.

Fundraising is not an activity that can be successfully confined to the periphery of the organization, and a nonprofit that seeks to increase philanthropy may need to accept fundamental change as the price for expanding its financial resources.

The COVID-19 pandemic and the murder of George Floyd in 2020 marked significant events for society and for the nonprofit sector. The consequences are likely to continue affecting the nonprofit sector and organizations in the years ahead.

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KEY TERMS

Accounts payable
Accounts receivable
Accrual basis (of accounting)
Advocacy organization
Board-designated endowment
Boundary spanners
Bureaucracy
Care (duty of)
Cash basis (of accounting)
Closed systems
Common goods
Community foundations
Endowment funds
Externalities
Failure theories
Free riders
Funding intermediaries
Goal displacement
Government failure
Grantmaking foundations
Institutionally related foundations
Loyalty (duty of)
Market failure
Mission drift
Mission-driven (organizations)
Mutual aid
National Taxonomy of Exempt Entities (NTEE)
Nondistribution constraint
Obedience (duty of)
Open systems
Operating foundations
Operating funds
Operating public charities
Organized entities
Permanent endowment
Permanently restricted (funds)
Pledges
Private foundations
Private goods
Public benefit
Public charities
Public goods
Pure endowment
Quasi-endowment
Resource dependence theory
Restricted (funds)
Self-governing
Service volunteers
Social welfare organizations
Supporting public charities
Supply-side theories
Systems (theory)
Tax deductible
Tax exempt
Tax expenditure
Temporarily restricted (funds)
Term endowments
Theory of the commons
Tradition of volunteerism
Unrelated business income tax (UBIT)
Unrestricted (funds)

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CASE 1.1: THE SMITHSONIAN INSTITUTION AND THE CATHERINE B. REYNOLDS FOUNDATION

The Smithsonian Institution, an educational and research institution in Washington, DC, is best known for its 19 museums and seven research centers. It is an unusual hybrid of federal government agency and nonprofit institution. It was chartered by Congress as a charitable

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trust in 1846, in response to a bequest from Englishman James Smithson, who left a gift to the United States of America to establish an institution "for the increase and diffusion of knowledge among men." But the Smithsonian is administered by the federal government, and courts have held that it is legally part of the federal government. More than two thirds of its workforce are employees of the federal government, while others supported by private funds are known as "trust fund employees." Although significant governance reforms were undertaken in 2007, in 2000 the Smithsonian was governed by a 17-member board of regents, including officials of the federal government and private citizens. The secretary of the Smithsonian is the paid chief executive, who is appointed by the board of regents. Throughout most of its history, the Smithsonian relied on ample funding from the U.S. government. But beginning in the 1980s, federal funds failed to keep pace with the Smithsonian's needs. Faced with a change in its environment, the Smithsonian "didn't exactly turn on a dime," and battles over the influence of private donors over the content of exhibits led to subsequent "knockdown, drag-out funding fight[s]," centered in particular on one of the Smithsonian's most prominent components, the National Museum of American History (Thompson, 2002).

By 2000, federal funds were only sufficient to cover the Smithsonian's core budget, including salaries. Private funds needed to be raised for new exhibits, and some standing exhibits had become dated. Deferred maintenance on the Smithsonian's extensive physical facilities had allowed many to deteriorate. Recognizing the need for change, the board of regents reached outside the scientific and museum communities for a new secretary, someone who could bring business methods and private resources to bear on the Smithsonian's mounting problems. Lawrence Small, appointed by the board of regents as the new secretary in 2000, came from a background in banking and finance rather than science or museum management. Small noted the deteriorating condition of the Smithsonian's facilities and the continuing decline in federal funds and committed himself to "a vision that involves two M's: modernization and money," with most of the money to come from more aggressive fundraising in the private sector (Thompson, 2002, p. 22).

Small had met Catherine B. Reynolds, a Washington-area entrepreneur who controlled a large foundation bearing her name. She shared Small's view that the National Museum of American History needed to be updated, and in May 2001, she announced a gift of $38 million from her foundation to support a project on which she and Small had agreed: a 10,000-square-foot "hall of achievement" exhibit, intended to portray the lives of eminent Americans. Small and Reynolds had agreed that the selection of individuals to be portrayed would be determined by a special advisory committee of 15 people, with 10 being appointed by the Reynolds Foundation. The *Washington Post* reported that the contract between the Reynolds Foundation and the Smithsonian provided that if the committee could not agree, the dispute would be resolved not by the curatorial staff but by the secretary himself ("Museums and Money," 2001).

The museum's staff erupted in anger, writing directly to the Smithsonian board of regents saying that the obligations Small had made to the Reynolds Foundation "breach[ed] established standards of museum practice and professional ethics" (Thompson, 2002, p. 26). The story caught the attention of the news media, resulting in a flurry of stories representing the museum curators' views and a *New York Times* editorial asking, "What is the curatorial rationale for a permanent exhibit that seems to open the door for commercial and corporate influence at one of the capital's keystone institutions" ("Gifts That Can Warp," 2001). The American Historical Association, including prominent historians among its members, joined the debate in support of the museum

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staff's views. Museum staff began to post "Dump Small" stickers in elevators, on bulletin boards, and on their own lapels (Sciolino, 2001b). A series of meetings was held between the curators and Ms. Reynolds to try to reach a common understanding, but they did not resolve the differences.

At least two issues were central to the controversy. The first was a difference in philosophy about the meaning of history and the purpose of museums. Historians and museum curators believed that the purpose of museums was to educate and that the study of history should not focus on the personal stories of "great" men and women. Rather, they argued that the teaching of history should focus on broad historical forces and movements, often portrayed in exhibits through their impact on the lives of everyday people. They believed that the purpose of a museum was to encourage people to think critically about history, not to inspire people personally. As one curator expressed it, "We are not a great man/great woman place . . . . This museum is about context, about putting people and events in place within the social fabric" (Thompson, 2002, p. 18). But Ms. Reynolds held a different view of history and the purpose of the museum's exhibits—it should be to inspire young people by portraying the lives of famous Americans and extolling the virtues of entrepreneurship in achieving success. "The foundation was created out of a very entrepreneurial business," Reynolds said, "and that is the spirit and culture we want to apply to the philanthropic world" (Sciolino, 2001c).

The second, and broader, issue was the question of who should control the content of museum exhibits—professional historians and museum curators or donors. To what degree should private donors have a say in museum exhibits to be developed with the money they are voluntarily giving? One scholar asked, "Will the Smithsonian Institution actually allow private funders to rent space in a public museum for the expression of private and personal views?" (Thompson, 2002, p. 16). Scholars accused Small of "selling" the museum to wealthy donors, with jeopardizing the "integrity and authority" of professional curators, and with having "[preempted] the issue of control" by reaching an agreement with the Reynolds Foundation without adequate consultation with his own staff (Sciolino, 2001c).

Small responded, saying that "government funding cannot do it all" and pointing out that the idea of private donors—who had something to say about how their money would be used—was not exactly new. After all, the Smithsonian Institution had been founded with James Smithson's gift! Small said, "We make no apologies for seeking private support to develop programs or facilities that the public wants and benefits from." He argued, "In all cases, we retain intellectual control while demonstrating to donors that their money can be spent productively and prudently. Does that mean we don't consult them? Of course we do. But the Smithsonian regents and staff control, without limitation or question, the Smithsonian activity" (Small, 2001, p. A25).

In February 2002, Reynolds canceled the bulk of her foundation's pledge to the Smithsonian, saying merely that she felt the exhibit would not adequately portray "the power of the individual" (Lewis, 2002). But important questions remained, for the Smithsonian and generally for other organizations. Like the Smithsonian, others have long relied on relatively assured sources of revenue, perhaps the government, a single foundation, or some other generous source. But many find themselves

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now needing to pursue new and more diversified sources of financial support. The questions that need to be addressed clearly go beyond the specific one raised by the Reynolds Foundation's gift to the Smithsonian, that of how history should be portrayed and who should decide. There are more generic questions: What trade-offs are appropriate, realistic, and necessary for institutions and organizations striving to meet their financial needs and develop new sources of revenue while preserving their traditional missions and values? And how can CEOs meet expectations for their leadership in such a time of change?

In years following the cancelation of the Reynolds Foundation pledge, the Smithsonian's approach to fundraising expanded and evolved, becoming more professionalized and effective. By 2018, it had completed a campaign that raised $1.9 billion, the largest amount ever raised by a cultural institution. It had come to be identified as "a public-private partnership between the U.S. federal government and generous donors and members" (Smithsonian Institution, 2018). In 2022, the Smithsonian was planning construction of two new museums—the National Museum of the American Latino and the American Women's History Museum—with the expectation that both would be funded through a combination of public and philanthropic resources (Smithsonian Institution, 2022).

Source: This case is adapted from Worth, M. J. (2021). *Nonprofit management: Principles and practice* (6th ed.). SAGE. *Additional Sources:* Cash (2002); Sciolino (2001a).

Questions Related to Case 1.1

1. How do the concepts of closed systems and open systems apply to the case of the Smithsonian and the Catherine B. Reynolds Foundation?
2. How does the theory of resource dependence apply to the case of the Smithsonian and the Catherine B. Reynolds Foundation?
3. How does the concept of boundary spanners apply to the case of the Catherine B. Reynolds Foundation? Who played that role in this case, and were there others who should have been more involved?

QUESTIONS FOR DISCUSSION

1. Pick a nonprofit organization with which you are personally familiar—maybe one where you have worked or been a volunteer—and examine its Form 990 (or annual report) to determine its sources of revenue. Based on that information, where does the organization lie in the quadrants depicted in Figure 1.2? Does that position coincide with what you may know about which positions hold power within the organization and with its culture?
2. If a nonprofit organization derives a substantial portion of its revenue from fees for service, that is, if it operates much like a business, would you be less inclined to support it with a charitable gift, or would that not make any difference? Explain.

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3. Do you think that the failure theories provide the best explanation for the existence of the nonprofit sector or is it better explained by the altruism of people who support it?

SUGGESTIONS FOR FURTHER READING

Books

Ott, J. S., & Dicke, L. A. (Eds.). (2021). *The nature of the nonprofit sector* (4th ed.). Routledge.

Powell, W. W., & Bromley, P. (Eds.) (2020). *The nonprofit sector: A research handbook* (3rd ed.). Stanford University Press.

Worth, M. J. (2024). *Nonprofit management: Principles and Practice* (7th ed.). SAGE.

Articles

Froelich, K. A. (1999, September). Diversification of revenue strategies: Evolving resource dependence in nonprofit organizations. *Nonprofit and Voluntary Sector Quarterly*, *28*(3), 246–268. (*Note*: This article is dated but still widely cited as a classic.)

Steenburg, E. V., Anaza, N. A., Ashhar, A., Barrios, A., Deutsch, A. R., Gardner, M. P., Priya, P., Roy, A., Sivaraman, A., & Taylor, K. A. (2022). The new world of philanthropy: How changing financial behavior, public policies, and COVID-19 affect nonprofit fundraising and marketing. *Journal of Consumer Affairs*, *56*(3), 1079–1105.

Winters, M-F. (2020, October 14). Equity and inclusion: The roots of organizational well-being. *Stanford Social Innovation Review*. https://ssir.org/articles/entry/equity_and_inclusion_the_roots_of_organizational_well_being

Websites

Internal Revenue Service: https://www.irs.gov/charities-and-nonprofits

Independent Sector: https://independentsector.org/

Urban Institute Center on Nonprofits and Philanthropy: https://www.urban.org/policy-centers/center-nonprofits-and-philanthropy

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NOTES

1. Technically, although the terms are often used interchangeably, nonprofit and tax exempt are not exactly the same, since there are some business entities that are tax exempt and there are entities that are taxed but do not distribute profits to owners. In addition, nonprofit is a legal status, since most organizations identified that way are incorporated under state law as non-profit corporations. Tax exemption is a status conferred by the federal tax code.
2. Section 501(c)(4) organizations also include some large health maintenance organizations.
3. Economists make a distinction between pure public goods and quasi-public goods. The distinction involves two characteristics of pure public goods: nonexcludability (no one is excluded from using pure public goods) and nonrivalry (use by some does not reduce the amount available for others). The discussion here is generally referring to quasi-public goods. For simplicity, they are just called public goods in this text. Some authors use the term social goods (Mitchell & Schmitz, 2019).

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