A Method for Measuring and Partially Testing ‘Charitability’

By Eugene Steuerle

Eugene Steuerle is a senior fellow at the Urban Institute.

Copyright 2007 C. Eugene Steuerle. All rights reserved.

First of Three Parts: Balancing Uses and Sources of Charitable Funds

How charitable are charities? Can a charity that provides education or healthcare and has no profits be “noncharitable”? The Senate Finance and House Ways and Means committees think those questions are so important that they have been examining whether and when nonprofit hospitals deserve tax exemption. Many state and local governments have done likewise. And apart from any possible action of the IRS or Congress or state legislatures, Independent Sector and other institutions serving and monitoring charities have been giving increased attention to how charities can more effectively achieve their charitable purposes. Even if there were no outside pressures, the community of consultants and advisers to charities would seek to find ways to measure success by more than sustainable budgets or outputs such as meals served or babies delivered.

All those efforts at one level or the other raise the important and sensitive issue of measurement. I contend that there is one powerful tool that could be used by many nonprofit organizations to try to more effectively measure — at least in one important respect — whether they are “charitable” and, to some degree, the extent of their charitability.

The measurement tool I suggest charities use is nothing more than the accountant’s most powerful tool: the balance sheet. However, the balancing exercise I am recommending goes beyond the traditional balancing of assets and liabilities and to what I will call the uses and sources of resources intended to achieve private charitable transfers.

Think about it: Most charities claim to be achieving their purposes in part by making some net charitable transfers of private resources to someone or for some cause. There must then be sources for those transfers. I suggest that by trying to balance those uses and sources for charitable transfers — that by lining up claims of charitable transfers made with the sources for those charitable transfers — a charity can discover much about itself and reveal much about itself to others. If there are no private sources, of course, there are no private transfers.

The Power and Limits of the Measure

This tool offers a way for a charity to examine itself and to be examined regarding far more than just charitability or qualification as a charity — an uninteresting question for most charities, we would hope. Most charities that seek to be charitable could easily pass almost any test for simple charitable status and still not be very effective in their charitable efforts. This balancing exercise provides a further means for a charity to discover whether its intended charitability matches up on the uses and sources side of the ledger. Along the way, the exercise could reveal possible limitations and inconsistencies that could compel an organization to reorient its activities and ways of operating. It is easy for an organization to assume it is acting charitably without ever testing that assumption. (Frances R. Hill makes some similar arguments about examining charitable efficiency, establishing a nexus between uses and sources and even trying to determine whether charitable resources have been diverted to such items as lobbying and commercial activities (see “Targeting Exemption for Charitable Efficiency: Designing a Nondiversion Constraint,” 56 SMU L. Rev. 675 (2003)).

Like all measurement tools, the balance sheet does not remove the need for other tools. A hammer doesn’t work very well on screws. Because the balance sheet exercise I am suggesting operates only along one dimension of charitability and at times requires qualitative assessment rather than quantitative measurement, it cannot be used to stack up charities and would-be charities along some continuum from most to least charitable. Businesses also know that their own balance sheets have limitations, say, in indicating the value of goodwill, training, and other human resources — but that doesn’t prevent the tools from being used.

Net Transfers and Charity

In referring to transfers by charities, I am not confusing myself to charities that provide support to the poor or even the middle class. Almost all charities claim to be transferring some services or goods to those who do not pay fully for them — or, in the case of certain “public goods,” do not pay at all. In the U.S., the IRS has moved far beyond its original inclination to consider as charities mainly those that redistribute to people in need. Efforts at improving education and healthcare, engaging citizens in civic activities, and advocating for a public cause often qualify as charitable. A worthy charity may even support richer members of society more than poorer ones. Still, I contend that almost all those charities engage in making net transfers to achieve their purposes. Thus, all of the following actions involve some transfer: advancing knowledge; granting emergency room care to those who can’t pay; engaging for the public good in acts of creation (research or art), prevention (disease or pregnancy), or promotion (health or exercise); developing alternative sources of media information; or providing for free...
attendance at church events for those who do not put money in the collection basket.

Indeed, what typically distinguishes a charity (or a charitable act, which need not take place in a charity) from a private business is the willingness to engage in those actions in ways that involve some net transfer of resources, rather than performing them solely or mainly for private gain. Businesses engage in exchanges when both parties to each exchange — consumer and producer, or business and business — profit from the bargain. There is generally no attempt to make additional net transfers from one to the other or to advance some public good. Each expects to maximize its own profit or gain from the exchange. While charities may do many things like businesses do, they claim to be doing something more as well, or they wouldn’t be charities.

While “something more” usually involves some net transfers, I do not mean to exclude other attributes from the definition of a charity. Indeed, there are competing ways of trying to define what it means to be a charity, none of which alone is wholly satisfactory. Evelyn Brody suggests that regarding churches, for instance, we include as charities (or at least as entities eligible for tax exemption and the charitable tax deduction) some organizations that are sovereign in their own realm.

Perhaps the two most common ways of defining charities are through the activity itself and the lack of profits or owners. Those two qualities — a recognized charitable activity and the so-called nondistribution constraint — may be legally necessary for some purposes. Some might even be tempted to suggest that they are sufficient for legal line-drawing as to whether an organization qualifies as a charity. But they are not very satisfying, in part because they can also apply to many businesses. Consider first the nondistribution constraint. Some partnerships can operate so that there is no current surplus or buildup of assets to be distributed. A not-for-profit business entity can extract maximum advantage for its partners or workers without any intent to serve the public good.

Defining a charity by its activity has become less of a meaningful distinction. As Prof. Joseph Cordes of George Washington University and I have shown, the industries and occupations that are expanding most in developed countries are those in which the activity qualifies easily for charitable status. Think of healthcare and education and information and you can see how rapidly the economy is moving in this direction.

The rising correlation between business and charitable outputs, and between the skills employed in private businesses and charities, helps explain why charitable has become an increasingly important topic. The traditional boundaries between business and charity break down more all the time as businesses find ways to make profits in areas nonprofits first pioneered. The boundaries among government, nonprofits, and business have also eroded as governments elect not to provide services directly but to contract out for them — driving businesses and charities to compete to provide services at one time associated more exclusively with either charity or government.

In this new world, it will be necessary to use additional measurement tools like the one I suggest here. Although this balance sheet exercise may not be sufficient to hold charities accountable regarding their missions or to determine whether they cross some legal line between being charitable and noncharitable, it still provides a very useful cross-check to determine how they differ from profit-making businesses.

Next Part: Applying the Tool