Accounting and Economic Biases in Donations to NGO's:

Is Scaling The New Overhead Myth In Charity Giving?

John Byrd,[a] Jane Cote[b]

a. University of Colorado at Denver,

b. Washington State University

A B S T R A C T

We examine how two trends in choosing which NGOs or not-for-profit organizations to support create biases in the types of organizations that are supported and how that bias in giving may affect the impact of international development organizations, especially those whose mission is sustainable development. The two trends that we examine are: 1) basing funding decisions on an organization's overhead-to-program expenses; and 2) basing funding on the ability of the organization to quickly scale up their activities. Efficiency is appealing because donors want their contributions to be invested well. Scaling is attractive because the need in the developing world is huge and scaling allows more of that need to be met. While scale is a very appropriate metric for certain types of activities, as a sole funding decision criterion it has serious flaws. We argue that these biases result in suboptimal development activities and that donors need to develop a much more complex and nuanced approach to giving, based on outcomes determined by the clients being served.

ⓒ2016 IRABF All rights reserved.

1. Introduction

Donors to international development non-governmental organizations (NGOs) have a serious problem determining if their contributions are being used efficiently or effectively. Many problems that NGOs attempt to address do not have simple, easy-to-measure metrics of success. Often the locations or sub-groups that NGOs work with vary so much that comparability of results and thereby comparing efficiency between groups is difficult. Moreover, reporting of results can range from almost nothing to detailed reports rivaling mandated corporate reporting by the largest charities. Without reasonable metrics about outcomes and efficiency, donors were forced to make funding decisions based on their perception of the seriousness of the problem being addressed, the recommendations or cajoling of friends, and so on.

Over time people began to develop metrics designed to make giving more analytic. The first widespread attempt used an efficiency ratio. That approach created unintended problems and has been discontinued to some extent. Replacing it is an emphasis on scaling up. In this paper we discuss the rise and fall of efficiency measures as guides for donors to NGOs, then explain the newer focus on scaling. We critique the scaling criterion and explain why scaling may result in sub-optimal development outcomes. We conclude by giving an example of a more holistic approach to development that avoids the problems of scaling

2. Efficiency Metrics as a Funding Guide

Over the last 10 to 12 years several websites have emerged that provide data about not-for-profit organizations and NGOs. These *charity watchdogs* include Guidestar, CharityWatch, Charity Navigator and the Wise Giving Alliance. As financial data became more available potential donors were encouraged to consider an organization's overhead-to-program expenses as a key criteria for giving. Since donors could not observe how well resources were employed, a second-best approach was to control expenses. Said slightly differently, since outcomes were unobservable, inputs became the control metric guiding donations. The argument was that if this ratio was too high than insufficient donations were not making their way to programs, so the impact of the organization was not as great as that of organizations funneling more of each dollar into programs. Here is an excerpt from the CharityWatch website:

PERCENT SPENT ON CHARITABLE PURPOSE

This is the portion of total expenses that is spent on charitable programs. In CharityWatch's view, 60% or greater is reasonable for most charities. The remaining percentage is spent on fundraising and general administration.

Note: A 60% program percentage typically indicates a "satisfactory" or "C range" rating. Most highly efficient charities are able to spend 75% or more on programs.

(Accessed April 17, 2014 at http://www.charitywatch.org/criteria.html)

Over time the dominant rule-of-thumb about charitable giving became that no more than 20% of an organization's budget should go to overhead (fundraising and administration). Here is an example of this approach to giving from a group called The Giving Table in a blog entry by the group's founder, Nicole Gulotta, titled, Giving 101: Two Ways To Evaluate Nonprofit Financials (June 27, 2012)

80/20. A good rule of thumb is remembering the 80/20-rule. A financially healthy organization will support program areas with at least 80% of its budget. If it's closer to 90%, even better, but somewhere around 80% also means that the remaining 20% (or less) goes toward the essential but less glamorous overhead costs (like salaries and operating expenses),

and the majority of its funding directly serves its beneficiaries.

(Accessed April 17, 2014 at http://www.givingtable.org/blog/2012/6/27/giving-101-two-ways-to-evaluate-nonprofit-financials.html)

A related concern was the amount NGOs spent on fundraising. This component of overhead was considered particularly wasteful. Here the rule of thumb was that fundraising costs should be as low as possible. Organizations responded to these incentives. Wing et al (2006) report the unbelievable statistic that, "One-fourth of nonprofits reporting $1 million to $5 million in contributions report zero fundraising costs, as do nearly one-fifth of those reporting more than $5 million in contributions." Somehow donations were solicited, grants written, monies received, deposited, and acknowledged at no cost to the organization whatsoever.

3. Problems Created by the Focus on Expenses

The almost incredible fact of zero fundraising costs reported by a significant proportion of large nonprofits suggests that administration expenditures were misallocated or purposefully manipulated to give donors what they wanted to see. A similar result applies to the overhead-to-program ratio with some observers suggesting that organizations were manipulating their financial results (Trussel, 2003). As in for-profit organizations, incorrect accounting items reduce the ability of organizations to manage their resources, evaluate their performance and outside users of these reports cannot make informed decisions. As NGOs responded to the incentives created for lower overhead and reported, either actual or manipulated, lower ratios, this became the expectation of donors.

This expectation for lower and lower overhead ratios by donors was identified as a potentially serious concern for the viability of many NGOs. This has been labeled the *starvation cycle*. The starvation cycle arises when organizations try to meet the expectations of donors for lower and lower overhead expenditures, resulting in an under-investment in organizational capacity and fundraising (Lecy and Searing, 2014, and Gregory and Howard, 2009). Without appropriate and sufficient administrative support programs cannot function, or cannot function effectively, staff cannot be trained and new programs cannot be developed. Here is how Gregory and Howard (2009) describe the starvation cycle:

The first step in the cycle is funders' unrealistic expectations about how much it costs to run a nonprofit. At the second step, nonprofits feel pressure to conform to funders' unrealistic expectations. At the third step, nonprofits respond to this pressure in two ways: They spend too little on overhead, and they underreport their expenditures on tax forms and in fundraising materials. This underspending and underreporting in turn perpetuates funders' unrealistic expectations. Over time, funders expect grantees to do more and more with less and less—a cycle that slowly starves nonprofits.

This problem became sufficiently acute that in June of 2013 the charity watchdog groups, BBB Wise Giving Alliance, Charity Navigator, and GuideStar, posted a letter to a new website, aptly named http://overheadmyth.com, urging donors to move beyond overhead ratios as the primary performance measure of nonprofit organizations. That these groups, which were designed to help donors select effective organizations, felt compelled to issue such a plea shows how harmful focusing solely on the overhead criterion had become.

4. Scaling-up as the New NGO Funding Metric

While problems of using overhead or fundraising expense ratios to evaluate not-for-profit organizations are being addressed, a new trend that may be equally problematic is emerging. Donors are being encouraged to consider an organization's ability to scale-up it activities. The argument is that the need in areas such as international development is so great that NGOs must scale-up to meet that need and to have more impact. This is a shift from examining inputs (overhead and fundraising costs) to looking at outputs (number of communities or individuals served, number of schools built, inoculations delivered, etc.). However, it may have its own problems equivalent to those of the overhead starvation cycle.

The new emphasis on scaling up is shown by a recent flurry of articles on the topic. For example, the Stanford Social Innovation Review produced a supplement on scaling up in April 2014 with 11 brief articles. This article set was produced in conjunction with Grantmakers for Effective Organizations and was targeted to funders. At least two organizations, the Social Impact Network and Growth Philanthropy Network, exist solely to help NGOs scale up.

The notion of scaling-up effective programs is very appealing. It is hard to argue that fewer people should be served or that communities should be less healthy than they might otherwise have been. Scaling, or the efficient and broader delivery of services, is perfectly appropriate of some activities. For example, malaria nets, vaccinations and immunizations and pre-natal nutrition are activities that should be delivered as broadly and efficiently as possible. However, the shift from looking at inputs to looking at outputs, still doesn't measure what is important, outcomes.

Output measures tell us about the number of people served, the number of schools built, or injections given. These metrics, and others such as life expectancy, infant mortality, disability-adjusted life years (DALY) and household income, are one step closer to outcomes than the overhead-to-program ratio, but still miss the ultimate target. All the conventional measures might be judged as acceptable or good, but that doesn't necessarily mean that a community has reached the goal of sustainable development, which should be a community that is healthy and capable of identifying and solving its own problems in a way that respects its culture and environment. The various health and demographics metrics need to be in an acceptable range for sustainable development to occur, but they do not assure that the end goal has been achieved. If injections of aid improve those metrics, but the community has not evolved, then those measures could deteriorate and future aid will be required to once again move them into the acceptable range.

5. The Problem with Scaling as an Objective

Scaling in the NGO world takes much from economies of scale in commerce. In economics, economies of scale means doing something with increasing efficiency. The way economics of scale are achieved is by having a standardized product, buying in bulk, having specialized machines and labor that quickly make the desired product. Products lend themselves to economies of scale but many services do not. If development is about delivering products then scaling may be effective. If development has a social or service component scaling may not be possible, effective or desirable.

A few examples may help explain why economies of scale may exist in some areas but not others. Suppose an NGO is created that repurposes shipping containers into classrooms. A factory is built that very efficiently makes the necessary modifications and an efficient delivery

system is devised. Classrooms are brought to villages and connected into schools. The factory with specialized labor and bulk purchases of materials is a very efficient system for producing classrooms. This process can be scaled-up by building another factory and increasing whatever delivery method is used. Another example is immunizations. Buying in bulk and training people to give shots or oral vaccines can very efficiently deliver the desired medicine. Increasing order size and training more people increases the scale of the operation.

The classic example of an activity that doesn't lend it self to economies of scale is an orchestra playing a symphony. There is some minimum number of musicians required and the time it takes to play the piece is the same today as when it was first performed. Some aspects of education cannot be made more efficient because children may have developmental limits on what concepts they can learn. Hospital procedures are slowly becoming more efficient but the time to deliver a baby, recover from surgery, rehabilitate an injury are changing only slowly or not at all. Having a group reach a consensus may also not be susceptible to economies of scale. It takes time for people to consider alternatives, voice their concerns and come to terms with some sort of compromise. This process could be hurried along, but some people may feel that their concerns weren't heard, and will not truly accept the final decision.

If scaling-up is the dominant criterion for funding NGOs then those that produce an easily replicated product or service will be funded and other organization won't. While this funding model will support activities like immunizations, it would not support activities such as community-building, many types of education (except for infrastructure) and some types of health-care. Nor would such a funding model allow for variation from the standardized product. If a community would be better served by something different than the standardized, but cost-effective, item, it would have to make-do. In the next sections we discuss why scaling as a funding criterion can lead to sub-optimal development results using an example from a development organization working in Nepal. Before we discuss the example, we will define what the goal of sustainable development is that we are trying to attain.

6. The Goal of Sustainable Development

We have adopted a definition that is slightly different than that used by the United Nations and other large international agencies, though there may some we haven't survey with a definition similar to ours. The UN says:

The ultimate goal of sustainable development is steady progress towards a future of universally shared human well-being and prosperity within the finite resources of the planet. Sustainable development is based on the knowledge that there is an ultimate limit to the growth of material consumption, but no limits to improvements in quality of life, prosperity or social well-being.
(UN, 2010, page 13 at:
https://sustainabledevelopment.un.org/content/documents/668prepcommittee.pdf)

We modify this slightly to include the notion that sustainable communities have the social and educational skills necessary to identify and solve their own problems. This does not mean that all solutions come completely from the community. Instead, it means that the community has the capability to identify needs and find sources to address those needs. Moreover, the community chooses solutions that maintain its social cohesion, the integrity of its environment or resource base, and respect its culture. Our modification does not preclude communities from asking for help, but it does argue that communities should be the first-movers in figuring out what changes they want and be able to define the terms of external intervention.

This slight change is subtle. It says that sustainable development occurs when communities have become sufficiently empowered to envision and determine their own destiny rather than relying on the vision of outsiders. The parable of sustainable development "teach a man to fish, feed him for a lifetime," captures this notion well. Once the man can fish he doesn't need help. He begins to control his own life.

7. An Example of Sustainable Development

The ultimate goal, though somewhat vague, might be captured by community prosperity or well-being. The notion is broader than just life expectancy or even health in general. The ultimate outcome of development should consider health, education, culture, income and other measures. For example, the dZi Foundation, a Colorado-based NGO working in eastern Nepal, has developed a measure of prosperity that includes seven elements. Community members developed these elements after a number of discussions facilitated by dZi foundation staff (Nepalis from the communities or nearby villages trained by dZi to lead such discussions).

The elements that the communities identified are:
- Health
- Wealth
- Unity
- Awareness/Education
- Culture
- Infrastructure
- Environment

Community members want a somewhat balanced approach to development that shows advances (or no deterioration) in all elements. So, for example, they are unwilling to sacrifice the environment or give up cultural identity to increase income. There are minimal levels of health that matter. What matter most to one community may be less important to another because that need has been met or other needs are greater. Moreover, sometimes the need identified by a community as most important completely surprises dZi's staff, so much so that the staff would have never thought of it as important.

That communities prioritize needs differently than NGOs is important. It reinforces William Easterly's assertion that NGOs often "determine what to supply" rather than finding out what communities want or need. Scaling up implies that communities need whatever an NGO can supply, and that many communities need the same intervention. While a one-size-fits-all approach may be appropriate for the very poorest communities where not even the most basic health and nutrition needs are being met, it may not be true for other communities.

Imagine a trajectory of optimal development based on these seven elements. This trajectory would vary from village to village depending on existing health, wealth and infrastructure. The environment will dictate what possibilities or opportunities exist. History, education levels, and commitment to culture will determine what is the most important change, the change that most improves community prosperity. Diagram 1 shows three such trajectories, with prosperity on the vertical axis and time on the horizontal axis. The trajectories vary because each community currently has a different combination of the seven elements, and a different priority for what will add the most prosperity at each stage of development. That is, some communities may have a good source of water but a poor school or lack of access to medical services, while others have a reasonable school but lack a good way to get crops to market. At any point in time, such as A each community would be best served by a certain change or

intervention. For some communities it might be a better school, for others improved income generation, and so on. An NGO focused on scalability will apply the same intervention to all communities whether that serves the community best or not. While sub-optimal activities may still benefit the community they will not move the community along the optimal development path. Instead they shift the community onto a somewhat lower path as shown in Diagram 2.
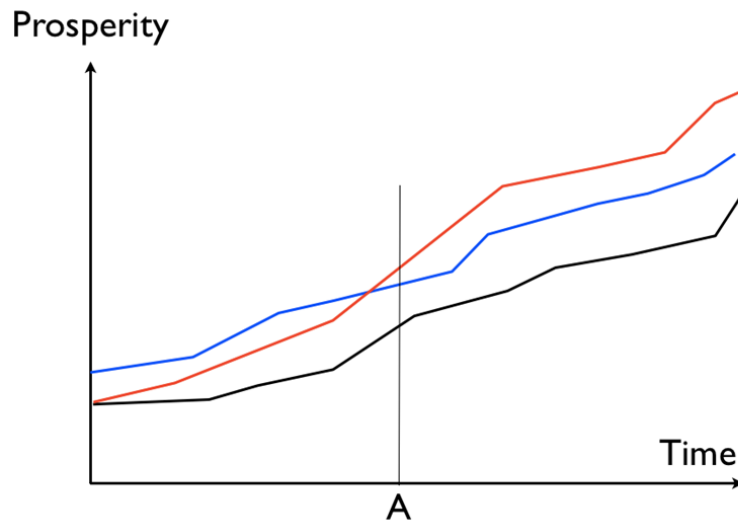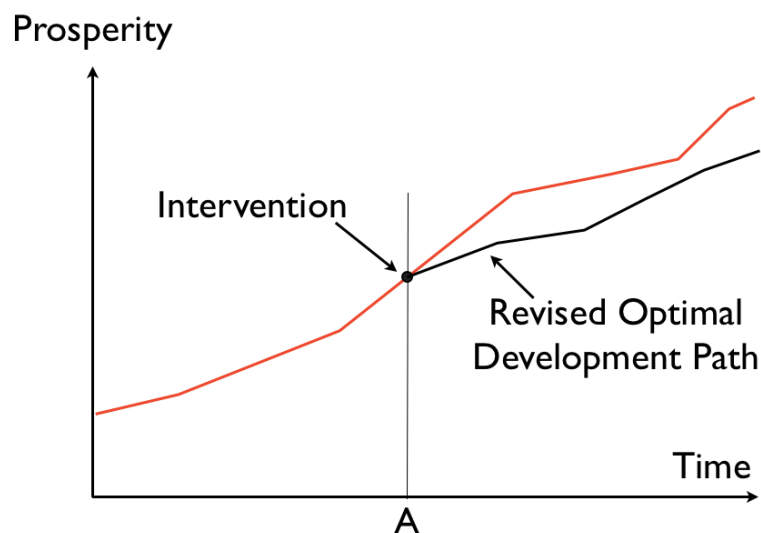
Diagram 1

Prosperity

Time

A

Diagram 2

Prosperity

Intervention

Revised Optimal
Development Path

Time

A

There are other effects of international organizations determining a community's needs. Being removed from the decision and planning stages means aid recipients never develop those skills or capacities. Moreover, since the aid agency delivers the project other organization skills such as project management and accountability for resources is not learned.   Under this type of regime communities will continue to be dependent on aid agencies to identify needs and deliver solutions.

Beyond the lack of capacity building there can a more subtle effect when communities are dependent on aid suppliers. The arrival of western aid workers to solve problems that the community could not solve (or could not afford to solve) may have a psychological effect on community members reinforcing doubts about their ability to address important community problems. Bauer (1976) states it this way:

The emphasis on the indispensability of aid is especially likely to exacerbate any feelings of inferiority, which some sections of the populations of underdeveloped countries may experience in their relations with the west, a feeling which is widely present though not always apparent and rarely acknowledged. (page 113)

These two concerns undermine one of the aims of many development programs – sustainability. Many aid programs tout their sustainability. But when aid is identified and delivered by donors, without developing the capacity of communities to solve their own problems, find their own funding, and run their own programs, the sustainability is of a very limited type.

By involving communities in their own future by building capacity and teaching decision and accountability processes while supporting development projects, an NGO may eventually be able to step out of a community knowing that people there can take care of themselves. After 5 years in the village of Rahka, in the Kotang district of eastern Nepal, dZi moved to other villages. The year after dZi exited, the community received funding for over 20 grants, worth almost $18,000, written to various Nepali government agencies and international NGOs. Building the capacity for the community to identify, design and manage solutions to its own problems provides a truly sustainable development strategy that cannot be duplicated with NGO designed and delivered programs.

8. Conclusion

Using metrics of inputs or outputs to guide the funding to development NGOs may lead to sub-optimal outcomes. We have shown that the focus on organizations with the ability to scale-up will fund a certain type of organization, but not others. We argue that to achieve true sustainable development communities will also need to develop in ways that don't lend themselves to scaling-up. By delivering standardized interventions, NGOs that focus on scale may put communities on sub-optimal development paths, limiting their ability to become self-determining.

References

Bauer, Peter T. (1976). *Dissent on Development: Studies and Debates in Development Economics*, Revised Edition, Harvard University Press.

BBB Wise Giving Alliance (2013). Charity Navigator, and GuideStar Join Forces to Dispel the Charity "Overhead Myth" June 17, 2013 at https://www.guidestar.org/rxa/news/news-releases/2013/2013-06-17-overhead-myth.aspx

Easterly, William (2006). *The White Man's Burden: Why the West's Efforts to Aid the Rest Have Done So Much Ill and So Little Good*, The Penguin Press, 2006.

Gregory, Ann Goggins and Don Howard (2009). The Nonprofit Starvation Cycle, Stanford *Social Innovation Review*, Fall 2009.

Hager, Mark and & Janet Greenlee (2004). "How Important is a Nonprofit's Bottom Line? *The Uses and Abuses of Financial Data*." Pp 85-96 in *In Search of the Nonprofit Sector*, edited

by P. Frumkin & J. Imber. Somerset, NJ: Transaction Publishers.

Lecy, Jesse D. and Elizabeth A. M. Searing (2014). *Anatomy of the Nonprofit Starvation Cycle: An Analysis of Falling Overhead Ratios in the Nonprofit Sector Nonprofit and Voluntary Sector Quarterly* 0899764014527175, first published on March 30, 2014 as doi:10.1177/0899764014527175

Kennard Wing, Teresa Gordon, Mark Hager, Thomas Pollak and Patrick Rooney (2006). "Functional Expense Reporting for Nonprofits: The Accounting Profession's Next Scandal?" *CPA Journal* August: 14-18.

World Health Organization (2010). Metrics: Disability-Adjusted Life Year (DALY): Quantifying the Burden of Disease from mortality and morbidity, at (http://www.who.int/healthinfo/global_burden_disease/metrics_daly/en/)

United Nations (2010. UN Report of the Secretary-General: Progress to date and remaining gaps in the implementation of the outcomes of the major summits in the area of sustainable development, as well as an analysis of the themes of the Conference, April 1, 2010.