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Philanthropic Social Capital Markets: Performance Driven Philanthropy

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INTRODUCTION

There is the assumption, sometimes explicit and other times implicit, that building organizational capacity in nonprofit organizations will contribute to organizational effectiveness or higher performance. For this paper, I am using the following definition for a high performance nonprofit organization: A nonprofit organization that achieves its mission by continuously satisfying the changing needs of its clients in a cost-effective manner.

Few would disagree that more money is needed to build, sustain, grow and improve nonprofit organizations. Directing more resources to this capacity building will help nonprofit organizations in their pursuit of high performance, yet it is well known that most grants are restricted to program support. But if high performance is to be achieved and sustained by nonprofit organizations, other structural dimensions of the nonprofit sector must be addressed as well.

Part of the reason for management's lack of focus on organizational performance may be attributable to endogenous characteristics of the nonprofit sector such as cumbersome governance structures, scarcity of professionally trained managerial staff, vagueness of mission etc. These organizational factors are certainly inhibitors to performance, but good leadership and more funds for capacity building can help overcome their impact. These factors, while important, are not the primary reasons why excellent organizational performance is so elusive in nonprofit organizations.

There is a more fundamental systemic reason that defies resolution within organizational boundaries: when capital is made available to nonprofit organizations and the terms and conditions of its distribution. It is the absolute amount of capital, the stages at which it is available during organizational development and the conditions of its acquisition that all work together to create a powerful influence on management behavior and organizational culture and, ultimately, on attaining high performance. This paper argues that philanthropy's influence on performance is far from neutral; it actually discourages management from pursuing performance as a primary objective.

The conversation must begin with an analysis of how and why the philanthropic capital markets, for the most part, fail to encourage high performance in nonprofit organizations. Ironically, nonprofit executive directors, in numerous interviews, consistently reported that excellent performance of a nonprofit organization is rarely systematically rewarded with an increased flow of philanthropic capital. In fact, an opposite situation prevails. As programs were proven effective and the nonprofit organizations developed plans to grow, foundations (even those currently funding their organizations) were less receptive to their requests for funding.

Luke O'Neill, founder and CEO of the nonprofit Shackleton School, described his situation in the following way, "The better the job my school does in educating its students, the better we all feel, but there is no clear correlation to increased donor support. In fact, most foundations tend to move away from funding the school as it becomes more established."

Nor is there a systematic reduction of philanthropic funds for mediocre performance. Examples abound of low performing nonprofit organizations that are kept afloat by sympathetic donors willing to contribute without objective data.

How and why is the current philanthropic system, which provides over $200 billion annually to U.S. nonprofit organizations, dissonant with encouraging high performance? What experiments for modifying existing philanthropic funding streams or creating new philanthropic social capital markets are being tried? What else might be done?

FOR-PROFIT CAPITAL MARKETS—A PERFORMANCE DRIVING CYCLE

It is instructive to begin by looking at the impact that for-profit capital markets have on corporate managers as a base line for discussion.
The characteristics of the for-profit capital markets are:

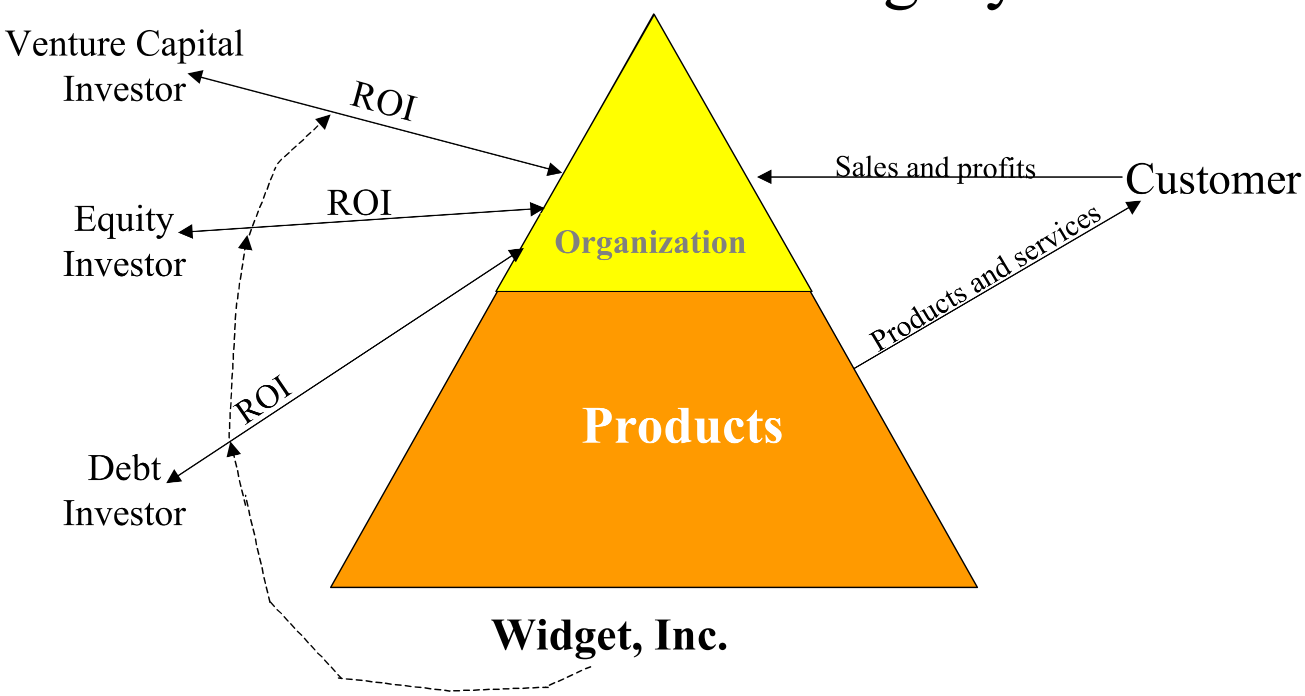
- At most stages of an organization's evolution there are substantial and identifiable, informal or formal, capital markets. These markets provide capital for what investors deem to be an appropriate rate of return, and this information is widely available to interested parties.

- While imperfect, capital providers have fundamentally transparent and relatively uniform criteria for making investment decisions. (A notable exception is for start-up capital where criteria are more idiosyncratic.) This information is also widely available to other investors and to those seeking the capital.

- Capital is usually provided for excellent organizational performance and withheld for its absence. This cause and effect continues over time—management's ongoing ability to cost-effectively satisfy customers' needs is a major determinant in its ability to systematically raise additional capital.

Chart 1

For Profit Capital Markets:
A Performance Driving Cycle



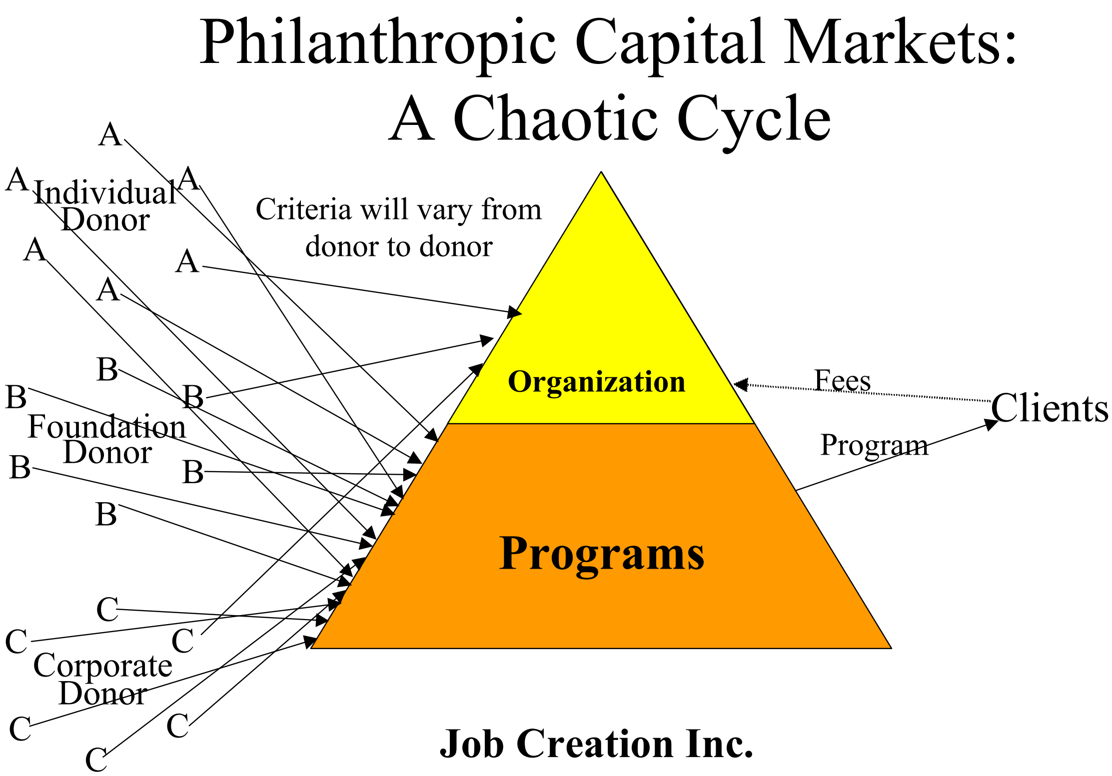
The greater the corporation’s ability to cost-effectively satisfy the customers’ needs > Sales and profit > Availability of funds.

All the pieces of the for-profit capital markets work together to create a closed loop, self-reinforcing system or a *performance driving* cycle. The capital markets become important influences on management behavior and organizational priorities. Managers are encouraged to seek ever-higher levels of organizational performance to ensure that the cycle repeats itself. Everyone in the sector knows the rules of the game and understands that failure to perform well breaks the cycle and has Darwinian consequences for both an organization and its management.

PHILANTHROPIC CAPITAL MARKETS—A CHAOTIC CYCLE

The picture of the nonprofit sector differs dramatically. The same components of the performance driving cycle exist—capital suppliers, capital, operating organizations and clients—but the way they work together creates a different set of dynamics. The philanthropic capital markets have three basic categories of donors— individuals, corporations and foundations--but within these categories are a large number of discrete actors moving in independent, highly personalized orbits. There are over one million independent nonprofit organizations trying to intersect with some sub-set of these capital sources. There are millions of clients who receive services from the nonprofit organizations, who often do not pay and rarely have formal feedback mechanisms to indicate their level of satisfaction with the quality of the service. The philanthropic capital market does have a distinct structure, but within that structure the components move in a fundamentally random fashion, creating something very different from a self-reinforcing system.

CHART 2



The greater the nonprofit organization's ability to cost-effectively serve the clients' needs ???? Revenue ???? Availability of funds

The following characteristics of the philanthropic capital markets prevail:

- The criteria for the allocation of philanthropic capital, from most sources, are idiosyncratic, often opaque, mostly ambiguous, and commonly based on personal relationships and reputation, rather than clearly promulgated objective data (NVSQ, Gronberg et al 2000).

- There are few identifiable sources of capital dedicated to each stage of a nonprofit organization's evolution, particularly for scaling-up and sustaining organizations. The length of the typical funding relationship is rarely geared to an organization's growth or operating requirements.

- Donors, for the most part, operate and contribute independently of each other. Broad-based mechanisms to aggregate funds, as is the case with for-profit equity markets, are rare exceptions.

- The motivations that drive donors to contribute to a nonprofit organization vary from donor to donor. Donor motivation need not and mostly is not linked, in any systematic or understandable fashion, to the specific needs of nonprofit organizations or the clients it serves.

- Metrics to evaluate organizational effectiveness have not been developed for most fields of nonprofit service delivery. If metrics do exist, they are not widely accepted by donors or by nonprofit organizations.

- There is no information system for measuring the effectiveness of philanthropic capital. Program evaluations conducted by foundations do not apply uniform criteria, even within the same field of service delivery, and are usually conducted retrospectively when the program is complete. The information generated is typically kept confidential and is not intended to enhance the effectiveness of their grant making or philanthropic capital markets.

Impact on nonprofit management behavior and priorities

While the for-profit capital markets encourage the pursuit of organizational performance, it is *still* a major challenge to build a corporate culture of high performance. The challenge is made more difficult for nonprofit organizations by the disorderliness and complexity of the philanthropic funding environment, which divert the focus of nonprofit managers away from organizational performance. Far from being benign, philanthropic markets have an insidious impact on getting and keeping high performance as a top priority for nonprofit managers.

FINITE MANAGEMENT TIME
To be effective, nonprofit CEOs must spend a great deal of time understanding and dealing with the complexities of the philanthropic market. Numerous interviews revealed that most executive directors spend from 40% to 60% of their time, either directly or indirectly, raising money--far more than their for-profit counterparts. The time absorbed to raise capital inevitably detracts from the available time needed for the never-ending leadership challenges of building organizational performance.

ORGANIZATIONAL COST
The acquisition costs of each dollar of capital in the nonprofit sector are considerable. Added to the cost of management time, are the costs of building and maintaining

complex infrastructures to identify, track and manage donors. Boards usually have to join in fund raising as well and are often distracted from the real business of governance. The resources dedicated to capital acquisition leave less for building performance capacity.

SCHIZOPHRENIC FORCES ON MANAGEMENT
Nonprofit managers must serve two sets of customers--the client and the funder. Aside from the fact that criteria measuring satisfaction for either of these groups need not exist, when criteria do exist, they can be widely divergent. It is more the rule than the exception that nonprofit managers struggle to balance the clients' needs with the donors' needs. Added to this already complicated balancing act is the reality that there are often multiple donors for the same program, each of whom may have a differing set of needs to satisfy (NVSQ, Moore 2000).

MEASUREMENT SMOKE SCREEN
There is no question that it is difficult to develop meaningful measurement for much of the work conducted by service delivery nonprofit organizations. But, many managers and boards do not focus on this difficult measurement challenge because, on average, they are not really rewarded to do so by philanthropic capital markets. However, they do suffer the consequences; the absence of objective performance measurement materially contributes to the randomness of the capital markets. How can markets be orderly, if there are no accepted standards to measure and compare absolute or relative organizational performance?

HUMAN RESOURCE SHIBBOLETH
Without consistent external rewards and sanctions from the capital markets, is it reasonable to assume that nonprofit leaders will struggle against the grain to build a high performance organizational culture? Because a culture of performance does not exist, nonprofit management is not systematically pushed to measure employee performance; has fewer resources available for employee training or for creating dynamic employment opportunities; and generally utilizes a workforce that has little prior understanding of, or orientation to, organizational performance.

LEVELING THE PLAYING FIELD

Experiments for Change

How to change philanthropy's influence on nonprofit management behavior and organizational priorities is receiving some attention in the philanthropic community. Capital flows are being used by a relatively small number of philanthropic entities to explicitly encourage organizational performance, often with the for-profit venture capital model serving as a metaphor for experimentation (Letts et al 1997). It is estimated that thirty-seven venture capital type philanthropic funds have been created or are about to be launched, including Entrepreneurs' Foundation, New Profits Inc. and the Roberts Enterprise Development Fund (Marino Institute 2001). A traditional foundation with assets of over $700 million, the Edna McConnell Clark Foundation has recently transformed its funding model to mirror many of the characteristics of venture philanthropy. While each organization's approach to applying the for-profit venture capital model to philanthropy varies, they all are establishing performance metrics for their "investments" and rewarding nonprofit performance with continued funding.

These are meaningful experiments, but the going is slow and the amounts distributed are, and will be in the foreseeable future, inconsequential as a percentage of annual philanthropy. If the current models distribute what they plan to over the next three years, they will give away, in aggregate, approximately $150 million, with Clark accounting for almost half the total. This will amount to .25% of the $625 billion of an estimated total giving in the U.S. over the same period. Nevertheless, these experiments have generated numerous heated conversations that often dwell on the appropriateness of using the venture capital metaphor to achieve social goals, rather than on the critical issue of the relationship between capital, management behavior and organizational performance (Foundation News and Commentary, Sievers 1997).

A few larger, more established foundations have re-oriented a portion of their grant making to reward performance. Disillusioned with the "entitlement mentality" of arts organizations and their failure to build high performing organizations after years of unrestricted funding, Pew Charitable Trusts created the *Philadelphia Cultural Leadership Program* in 1997. This program provides general support for three years exclusively to those arts organizations that score well on a homegrown set of objective performance metrics. The experiment has caused a great deal of public and grantee distress, but Pew is forging ahead with the program and is introducing modifications designed to improve communication, content and implementation. In the foundation world, there are few other examples of this kind of bold experimentation designed to drive nonprofit organizational performance.

Over the long term, these experiments may be too few and too late for sustaining a large number of service delivery nonprofit organizations. It is time to go beyond the discrete models and isolated foundation experiments. The emphasis and attention must become more expansive than individual experiments and address the systemic restructuring of philanthropic social capital markets.

WHO SHOULD LEAD INNOVATION?

Individual giving is diffused among countless individuals, is discretionary and is driven by a range of personal motivations. Because of growing interest in the venture capital model, and its comfortable conceptual alignment with many "newly wealthy" individuals, performance driven philanthropic experiments will likely continue. However, it is unlikely that this fragmented category of donors could lead a systematic approach to changing the philanthropic social capital markets. Corporate giving, while less fragmented, is similar enough to individual philanthropy that also makes it an unlikely category for leading broad-based sectoral change.

Endowed foundations are the most logical candidates for leading systemic change, and they have the human and financial resources to get the job done. The assets of America's 50,000 foundations are currently estimated to be over $448 billion with more than $27 billion given away in 2000 (Chronicle of Philanthropy, Wilhem 2001). Additionally, it is argued that foundations have a fiduciary responsibility to the general public to perform at a high level because they receive considerable tax advantages (HBR, Kramer & Porter1999). It is also reasonable to assume that many of the professionals who staff foundations take their responsibility for effectiveness seriously. Striving for optimum grant making impact should be a moral and practical imperative.

PUSHING THE ENVELOPE

FOUNDATION ACCOUNTABILITY, THE FIRST STEP

Foundations, as a financial sector, are unlike any other part of the U.S. economic or political system and are not, as a group or as individual organizations, formally accountable to any external constituency for their effectiveness. (Foundations are legally bound to maintain financial probity and distribute an average of 5% of their corpus annually.) There is no requirement, nor cultural orientation, to report to the public the results of individual grants or the effectiveness of multi-year grant making programs. It is difficult to find an example of a foundation that keeps internal records tracking the success and failures of its grant making. Although an internal governing board monitors the effectiveness of foundation giving, there is no uniform set of standards applied to activities, either within a foundation or across foundations, to determine success. The ability and will of boards to discharge oversight responsibilities, as with other nonprofit organizations, can and does vary considerably.

Meaningfully enhancing the effectiveness of giving inevitably requires a system of internal measurement and a mechanism to drive individual performance and accountability within a foundation. This is a challenging task for foundations, but a very doable one if there is the will. It would require a considerable reorganization in the way foundations conduct their business, and would necessitate changes in the way foundations collect and disseminate knowledge and compensate their professional grant makers.
It would be highly unusual for a group of professionals or organizations to voluntarily establish objective measures of individual and collective accountability and push for radical change, but this shift will be an essential element in enhancing organizational effectiveness in the nonprofit sector. Without a dynamic response to the increased questioning of the effectiveness of the nonprofit sector, foundations do run the ultimate risk of increased scrutiny from the public, press and government. Legislation mandating standards for the effectiveness of foundation giving is an unattractive alternative for driving change.

KNOWLEDGE CREATION AND INFORMATION SHARING

Formal and sustained dialogue around all aspects of systemic change is a good place to begin addressing the complexities of performance driven philanthropy. Forums should be created to bring together informed thinkers from the business, philanthropic, academic and nonprofit communities to analyze and understand performance driven philanthropy; and to design and propose changes to the system that foundations could then implement. These forums could be reconvened at regular intervals. Based on research data collected at every stage of implementation, this group would be perfectly positioned to evaluate the effectiveness of experiments and recommend modifications to enhance impact. An existing association, The Independent Sector for example, or a new entity could organize the forums, act as a clearinghouse for information, and promulgate information.

INDIVDUAL FOUNDATION EXPERIMENTS
A great many more foundations should undertake initiatives similar to the Pew Charitable Trusts' *Philadelphia Cultural Leadership Program* across a broad range of nonprofit industry categories. It would be beneficial for these foundations to coordinate their efforts, thereby allowing for a number of different approaches to performance driven philanthropy to be tried and evaluated simultaneously. A key element for rapidly spreading best practices would be a willingness of foundations to compare results and benchmark experiments against more conventional grant making approaches. The level of collaboration and transparency required for this kind of inter-foundation assessment is substantial and would demand a significant commitment from participating foundations.

CREATING CAPITAL POOLS
A bolder approach to systemic change would be to create models of rational performance driven capital markets that replicate the desired characteristics of the for-profit capital markets described earlier in this paper.

Foundations of all sizes could agree to contribute to newly created common pools of capital, dedicated to nonprofit organizational support rather than to direct programmatic funding. Each pool could be used to fund at a particular stage of a nonprofit organization's evolution from start-up, to scale-up to sustaining. As organizations pass through different growth phases, they would be eligible for funds from a different pool. The size of each pool would have to be substantial enough to fund organizations over a multi-year period and keep the attention of nonprofit managers.

The distribution of funds from these pools would be based on publicly promulgated standards of organizational performance. While many in the sector wring their hands over the lack of consistent and meaningful metrics, there is almost no organized and systematic effort by most capital sources to address this challenge. The difficulty in developing meaningful metrics should motivate, not inhibit the allocation of adequate resources to study and develop measurement tools.

With transparency as the standard, each pool could be administered by a neutral entity; have the credibility of large foundation and public oversight; and disseminate its criteria for success. The desired result would be intensified competition, around outcomes and impact, among nonprofit organizations who deliver service in comparable areas and who are at the same stage of organizational development.

If the results of the organizations funded by the pools are impressive and marketed well, these pools might, over time, attract substantial additional capital, as they do in the for-profit sector, (Gompers & Lerner 2000) to performance driven philanthropy. These pools could then be opened to all individual and corporate donors who wish to contribute.

It would be ideal for each pool to focus as narrowly as possible on a particular industry subsection, e.g., one for primary education, one for youth services. This could facilitate the development of metrics needed to compare organizational performance within a category of services. To promote buy-in at all levels, nonprofit organizations would work in partnership with academics and foundation representatives, to develop a process for creating, evaluating and modifying performance metrics. Performance measurement would become an incontrovertible component of a nonprofit manager's competition for funds and for the determination of effectiveness of pool managers distributing these funds. It is a fair bet that under these conditions, metrics that that had increasing relevancy and accuracy would evolve.

These pools would create benefits on a number of levels. They would:
1. Encourage the development of new performance metrics for emerging and established nonprofits and accelerate the development of existing initiatives, such as Robert Kaplan's Balanced Scorecard application to nonprofit performance and the Roberts Foundation's pioneering work on measuring social return on investments (SROI).
2. Broaden and refocus the dialogue in philanthropy away from the advantages and disadvantages of the venture capital model to a more basic question of how to create funding streams that support growth, sustainability and performance.
3. Accelerate the study of the relationship between organizational performance and enhanced social outcomes.
4. Introduce competition for funds among nonprofits around objective criteria, providing clear rewards for organizational excellence and encouraging under-performing nonprofits to improve or shut down.
5. Create a performance-based meritocracy, inducing managers of nonprofits to focus on building high performance organizations and spend more time on the service recipient.
6. Create a more level playing field for nonprofits to compete with their for-profit counterparts.
7. Enable the development of standards for success both within and across pools to measure the relative performance of grant officers.

RISKS OF EXPERIMENTING WITH SYSTEMIC CHANGE

Many in the foundation world hold the view that a primary role for their organizations is to encourage and test innovation. Experimenting with the way money is distributed and the management behavior it drives seems a worthwhile place to practice this role and could be a lot less risky to all stakeholders than having foundations spend their resources over and over again on new program design and implementation.

Is there a significant downside risk in restructuring some portion of the philanthropic social capital markets to test the effectiveness of performance driven philanthropy? The short answer is, "No." The current reality is that most broad-based solutions to social problems have eluded the conventional and fragmented approaches to philanthropy. It is hard to imagine that experiments to change the system to a more performance driven and rational market would negatively impact the effectiveness of the current funding flows--and could have dramatic upside potential.

Are there material risks associated with this type of funding experiment for service delivery nonprofit organizations? It is highly unlikely that taking time away from fund raising and making managers measure organizational performance will somehow move nonprofits away from their values. As long as organizational performance is coincident with the achievement of mission, then the benefits would far outweigh the risks. By aligning the needs of the client receiving the services with a funder's definition of success, performance driven philanthropy will move management away from worrying about serving two customers with different needs. Could this refocusing on the client possibly create a risk that is more unacceptable then the conditions that exist in philanthropic markets today? If existing foundations do not respond to this challenge, it is the sustainability of the service delivery nonprofits, and the ultimate welfare of the clients they serve and not the foundations, that are at risk.