

ECONOMIC ASPECTS OF REGULATING  
CHARITABLE SOLICITATION

by

Richard Steinberg\*\*

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\*\* Associate Professor of Economics, V.P.I. & S.U.

## I. INTRODUCTION

State regulators and federal legislators continue to seek ways to stem what they perceive as fraudulent or excessive fundraising practices, despite Supreme Court proscriptions against favored regulatory options.<sup>1</sup> In two previous papers,<sup>2</sup> I characterized these earlier regulatory stratagems as misguided, concluding:

"Fraud may indeed be a problem, but neither regulation of fundraising percentage nor point-of-solicitation disclosure does much to stem fraud. Indeed, these regulations would stem fraud only by sheerest coincidence. Direct enforcement of anti-fraud and inurement statutes may be difficult, but it would be no coincidence if they succeeded."<sup>3</sup>

In this paper, I reiterate those arguments applying to newer regulatory stratagems, and consider further the social costs of misguided regulations.

I consider three types of regulations - restraints on fundraising share, mandated disclosures, and consumer protection approaches. The Court has made it crystal clear

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1. The three most important of these are *Village of Schaumburg v. Citizens for a Better Environment*, 444 U.S. 620 (1980); *Maryland v. Joseph H. Munson Co.*, 467 U.S. 947 (1984); and *Riley v. National Federation of the Blind of North Carolina, Inc.*, 108 S. Ct. 2667 (1988). Post-Riley decisions of the lower courts include *Telco Communications, Inc. v. S. Mason Carbaugh*, 1989 WL 107186 (4th Cir., Sept. 20, 1989), 1989 and *Famine Relief Fund v. State of W. Va.*, Case No. 89-2167, U.S. District Court at Charleston, W.V. See Ellen Harris, Lynn S. Holley, and Christopher J. McCaffrey, "Fundraising into the 1990s: State Regulation of Charitable Solicitation after Riley," University of San Francisco Law Review (1990) [hereinafter *After Riley*] for a comprehensive review of likely permissible and proscribed methods of regulation following Riley, and the interesting critical review of this article by Henry C. Suhrke, Philanthropy Monthly, January 1990, p. 5-10. (Note - owing to time pressure, all page references for *After Riley* are from an earlier version circulated by NYU.)

2. Steinberg, Richard, "Economic Perspectives on Regulation of Charitable Solicitation," 39 Case Western Reserve Law Review 775 (1988-89) [hereinafter *Regulation*] and Steinberg, Richard, "Should Donors Care about Fundraising?," in The Economics of Nonprofit Institutions: Studies in Structure and Policy 347 (S. Rose-Ackerman, ed. 1986) [hereinafter *Should Donors Care*].

3. *Regulation*, supra note 2, at 797.

that direct restrictions on fundraising share (solicitation expenses divided by donations obtained) are proscribed under the First Amendment. It is impermissible for the states to place a ceiling on total fundraising expenditures or fundraising share, whether campaigns are conducted internally or via contract with a fundraising firm; consequently it is impermissible for the states to place a floor on program expenditures.<sup>4</sup> Nonetheless, proposals to indirectly regulate fundraising share proliferate. For example, one federal bill would require certain charities which solicit contributions from the public to use at least 50 percent of gross receipts for charitable purposes or forfeit their exemption from the federal corporate income tax.<sup>5</sup> Alternatively, a state could mandate disclosure of fundraising percentages to a state agency, which would then publicize these figures.<sup>6</sup> Such publicity would pressure charities to keep their fundraising shares lower than otherwise, even if it would not absolutely bar high fundraising percentages.

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4. In *Famine Relief*, supra note 1, the District Court upheld that portion of West Virginia's Solicitation Act which requires that expenditures be related in a primary degree to the stated purpose (programs and activities) described in solicitations, noting that this does not restrict the percentage spent for fundraising. It is unclear whether this decision would withstand further appeal, in light of *Schaumburg*, supra note 1, which affirmed the overturning of a village statute requiring that a minimum of 75 percent of receipts be devoted to "charitable purposes." The Court held (at 836) that the government's interest in "protecting the public from fraud, crime and undue annoyance...[is] only peripherally promoted by the 75-percent requirement and could be sufficiently served by measures less destructive of First Amendment interests." Although West Virginia's statute leaves the percentage requirement vague, percentage requirements are still only marginally related to the state's interests.

5. H.R. 2188, 100th Congress, 1st Session, 133 Congressional Record H2638 (daily ed., April 28, 1987).

6. Many states have adopted this approach, which, whether good public policy or not, seems to be clearly within constitutional bounds. See *After Riley*, supra note 1, at 89.

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It is clear that the states may not mandate point-of-solicitation disclosure of fundraising percentages following Riley. Notwithstanding this prohibition, Senator Metzenbaum has proposed a bill which would require charities to disclose, at the point of solicitation, the percentage of their total budget that is used for fundraising.<sup>7</sup> It is less clear whether states may mandate point-of-solicitation disclosure of other financial statistics and ratios or post-solicitation financial disclosures, although it seems clear that the state would have to justify such mandates as narrowly tailored to legitimate state interests.<sup>8</sup> Following dicta in Riley, several lower courts have upheld requirements for other sorts of compelled speech, such as point-of-solicitation disclosure of a solicitor's professional status, or required statements that 'financial statements are available'.<sup>9</sup> Similar bills have been introduced at the federal level.<sup>10</sup>

Under the rubric of consumer protection approaches, I include proposals to extend FTC consumer-protection jurisdiction to charities<sup>11</sup>, laws which require solicitation 'scripts' to be submitted to state agencies, and the extension of bonding requirements to all professional solicitors, regardless of whether they handle incoming

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7. 27(4) NSFRE News 1 (June 1990).

8. See After Riley, supra note 1, pp. 76-88.

9. After Riley, supra note 1, pp. 77-80.

10. Congressman Luken has introduced a bill that would require charities that use professional fundraisers to disclose this fact at the point-of-solicitation. See NSFRE News, supra note 7.

11. see Henry C. Suhrke, "Do we Need More Federal Fund Raising Oversight Added to State Regulation?," Philanthropy Monthly, June 1989, at page 5.

receipts.<sup>12</sup> Unlike previous use of bonding, designed to insure against embezzlement, new proposals are designed to insure the payments of judgments involving money raised through misrepresentation.<sup>13</sup>

In section II of this paper, I consider whether these regulations are well-suited towards achieving valid public purposes. I argue that financial statistics are not valid indicators of fraud, and that some allegedly misleading fundraising techniques are valid. In section III, I consider the social costs of these misguided attempts at regulation. These include compliance and regulatory costs, increases in misleading promotions and misled donors, inefficient generation of donations, inefficient provision of charitable output, and inefficient provision of information to donors. The final section contends that better enforcement of the non-distribution constraint is the best solution to alleged abuses in fundraising.

## II. ARE REGULATIONS WELL-SUITED TO ACHIEVE VALID PUBLIC PURPOSES?

'Fraud' is a loosely defined word; it has been bandied about so frequently in

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12. One court has rejected bonding requirements for any "paid promoters of the petitioning organization" as such bonds would amount to charging a fee for the exercise of free speech. *Holy Spirit Association for the Unification of World Christianity v. Hodge*, 582 F. Supp. 592 (N.D. Texas 1984). Another allowed bonding under a statute that exempted volunteers and applied only to "professional fundraisers who actually handle the money raised for the charity," noting the business-oriented nature of these professionals. *Heritage Publishing Co. v. Fishman*, 634 F. Supp. 1489 (D. Minn. 1986). See the discussion in *After Riley*, supra note 1, at 70.

13. (no author listed), "State Regulators are Still (1989) Coming to Terms With...Schaumburg (1980), Munson (1984), and Riley (1988)," Philanthropy Monthly, September 1989, at 21.

the fundraising field that one is suspicious that politicians have gotten the Supreme Court's dicta on pornography backwards: they see it when they know it. Two aspects of fraud are frequently alleged: that high fundraising shares betray the reasonable expectations of donors that their contributions will be devoted to charitable purposes, and that solicitation techniques have the capacity or tendency to mislead an ordinary man of common intelligence. Each is considered in turn.

A) Fraud as High Share

In his dissent in the Munson case, Justice Rehnquist argued:

"There is an element of 'fraud' in soliciting money 'for' a charity when in reality that charity will see only a small fraction of the funds collected. But even if a fundraiser were to fully disclose to every donor that half of the money collected would be used for 'expenses,' so that there would be no question of 'fraud' in the common-law sense of the word, the State's interest is not at an end. The Statute ... is also directed against the incurring of excessive costs in charitable solicitation even where the costs are fully disclosed to both potential donors and the charity. Such a law protects the charities themselves from being overcharged by unscrupulous professional fundraisers."<sup>14</sup>

Thus, Rehnquist argues that high shares identify fraud - either donors or the charities themselves must have been misled.

Although Rehnquist's views did not prevail upon the Court, they seemingly underlie recent attempts to indirectly restrain fundraising shares through threats of loss of tax exemption or adverse state-sponsored publicity. Thus, the views I expressed in Regulation<sup>15</sup> warrant reiteration: fundraising share is not an indicator of fraud.

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14. Munson, 467 U.S. at 980 (footnote omitted) (Rehnquist, J., dissenting).

15. supra, note 2.

Many of the reasons for this conclusion, as advanced by others, have been accepted by the majority of the Court. For example, in *Riley*, the Court reiterated its position in *Munson*:

"[T]he use of a percentage based test was not narrowly tailored to achieve [the] goal [of prevention of fraud]. In fact, we found that if the statute actually prevented fraud in some cases it would be "little more than fortuitous." An "equally likely" result would be that the law would "restrict First Amendment activity that results in high costs but is itself a part of the charity's goal or that is simply attributable to the fact that the charity's cause proves unpopular."<sup>16</sup>

Recipient charities (donees) should not care about fundraising share, but only about what they can accomplish as a result of the campaign. In turn, this depends upon the net returns from fundraising (i.e., the difference between donations received and fundraising costs), which is unrelated to the ratio of costs to receipts. For example, consider a donee who could spend \$1000 to raise \$10,000 (for a net return of \$9,000) or \$100,000 to raise \$150,000 (for a net return of \$50,000). Much more can be accomplished with the proceeds from the latter campaign, even though the fundraising share is substantially higher (10% vs. 67%).

Fundraising potential differs enormously across donees. New charities, or those supporting unpopular or controversial causes, will necessarily obtain high shares even if their fundraising campaign is optimally conducted by the cheapest available fundraising counsel. Large, established, and noncontroversial charities can have low shares even if they are being 'ripped off' by their fundraising counsel.

The proper test, from the donee perspective, would require one to determine

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16. *Riley*, 108 S.Ct. at 2673 (quoting *Munson*, 467 U.S. at 966-7).

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whether the same net returns could be generated from an alternative fundraising counsel (or internally-conducted campaign) using similarly-acceptable techniques. Acceptability from the donee perspective is rather important - misleading advertising clearly has the potential to increase net returns, but the existence of a low-cost fundraising counsel known for its 'sleazy' techniques does not render the employment of a high-cost counsel with a good reputation 'fraudulent.' Even so, I have trouble with the notion that employment of a higher-than-necessary cost campaign represents 'fraud' from the donee perspective. Small departures from minimum cost are expected for the same reason that different supermarkets charge different prices for the same good. If, for example, I pay 39 cents for a can of cat food at Kroger which could be obtained for 35 cents elsewhere, an 'unscrupulous professional food-marketer' has not defrauded me. I have simply been victimized by my choice not to do more research, which may have been quite rational since at some point, additional time spent researching cat-food prices (or fundraising counsel) could be better spent writing another paper (or seeing to the charity's other concerns). Drastic departures from minimum cost could result from the activities of 'unscrupulous professional fundraisers,' but they could just as well result from the donee's managerial inexperience or incompetence.

From the donor perspective, an important distinction should be drawn between the fundraising share (which, at best, represents the average returns experienced by previous donors) and the net returns from one's own contribution. Consider, as an example, a corporate underwriter who covers the entirety of costs for a \$10,000



campaign. Then, the first donor, considering adding a dollar on top of this corporate donation should regard the fundraising share as zero, as none of her donation is diverted from service provision. Conventional accounting rules would lead to a report of a 100% fundraising share, the very antithesis of the relevant share from the donor perspective.

The key, from the donor perspective, is not how much the charity budgets for solicitation, but how much that budget is adjusted in response to additional donations. I developed this point further in an earlier paper,<sup>17</sup> where I presented a mathematical model of the incremental service provision resulting from incremental donations. Incremental service provision was shown to depend upon three factors - the objective of the charity (which determines its behavioral response to incremental donations), the net productivity of induced incremental solicitation, and cross-donative effects when some donors shift from supporting one charity to supporting another. In general,<sup>18</sup> fundraising share is wholly irrelevant. Indeed, many cases are analytically equivalent to the example presented above, where the donor should regard 100% of his donation as service-providing regardless of the charity's fundraising

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17. Should Donors Care?, supra, note 2. A less technical summary of the main points of this paper can be found in either Regulation, supra, note 2, or in Richard Steinberg, "The Economics of Fundraising," forthcoming in Dwight Burlingame and Monty Hulse, eds., Taking Fund Raising Seriously (working title) (draft April 1990).

18. There are some mainly technical exceptions to this conclusion, where fundraising share is relevant as one of several determinants of the efficiency of incremental donations. However, even holding constant the other determinants, efficiency is not monotonic in share. Sometimes, an increase in share increases efficiency; other times the reverse is true. Thus, there should be no presumption that low-share charities are 'better buys' for donors.

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share.

When charities employ incentive contracts that obligate payment of a fixed proportion of net receipts to the fundraisers, the situation is different. Even if the charity did not want to increase its fundraising budget in response to incremental donations, this type of contract obligates such a response. This diversion of funds subtracts from the incremental service provided as a result of the donation. The fact that fundraising counsel may work harder because of the incentive contract is largely irrelevant to individual donors, even if it is relevant to the donor class as a whole. The reason is that the portion of the incremental donation which is diverted to the fundraising counsel provides only an incremental incentive to work harder. Although incentive payments may work well in total, increasing the size of the pie by more than enough to compensate for the loss of a slice, there are diminishing incremental effects to incentive payments, and the last dollar diverted results in little additional fundraiser effort.<sup>19</sup>

A portion of reported donations is really a purchase. Donors receive dinner, entertainment, front-row seats at football games, entry in 'charitable sweepstakes,' and alumni magazines. The value of such premiums must be subtracted from gross donations prior to taking an income-tax deduction. If 'donations' which purchase premiums are not really donations, then a charity's expenditure on premiums is not really a fundraising expense. Including both in the calculation of fundraising share

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19. See Regulation, supra note 2 and Richard Steinberg, "Profits as Incentives within Nonprofit Firms," 1(2) Nonprofit Management and Leadership, 1990.

artificially inflates the share, a point missed by many sensationalistic expos'es.<sup>20</sup>

It is not surprising that premium provision is so common in fundraising. Apparently, many tangible goods or services nicely complement donor desires to give. 'Piggybacking' strategies are recommended in management journals,<sup>21</sup> and used by economists to explain why donors do not 'free ride' off the donations of others.<sup>22</sup> One might regard premiums as a form of fundraising because they make fundraising easier. By extension, one would then regard the value of premiums as deductible on personal income tax returns because premiums make donating easier, a rationale hardly embraced by the IRS. Premiums are a distinct, if complementing, good, and expenditures by donors and donees on premiums should not count as fundraising.

Although the quid pro quo nature of a donation is clear in the above examples, the argument should be extended to less obvious cases. Donors often receive non-tangible goods in exchange for their contribution, including prestige, ego gratification, and the approval of one's boss, spouse, or friends. Sweet-talking by the college president (whose time is presumably of some value), or public recognition through

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20. For example, Henry Suhrke, commenting on reports issued by the Attorney General's office of Connecticut, argued: "[S]ome of these "reports" are scandalous misrepresentations of fund raising. They are computerized calculations of special events fund raising, which make no effort whatsoever to educate consumers as to the legitimate costs of special events fund raising and rely for their shock effect on an implied comparison with general fund raising costs. To label such activity as 'educational' defies comprehension." (emphasis in original). See Suhrke, supra, note 11 at page 6.

21. Nielsen, "Piggybacking Strategies for Nonprofits: A Shared Costs Approach," 7 Strategic Management Journal 201, 1986.

22. John Posnett and Todd Sandler, "Joint Supply and the Finance of Charitable Activity," 14 Public Finance Quarterly 209, 1986.

expensive awards banquets for volunteers may be necessary to secure donations. Yet properly speaking, a portion of each donation should be regarded as a purchase of these non-tangible goods, and the college president's salary or expenditures on the banquet should be regarded as a cost of sales, not fundraising.

Fundraising share is uninformative to both donors and donees for several additional reasons. First, current solicitation efforts have effects on future productivity. New donor acquisition campaigns are quite expensive - one must solicit almost blindly, hoping to strike a sympathetic chord in some donor's heart. Once found, new donors will continue to give (with little additional solicitation expenditure) for years. Typically, 60% of new donors will continue to give in the second year, and 80% of the remainder will continue in each successive year, absent major efforts at donor retention.<sup>23</sup>

Were this a for-profit business, proper accounting techniques would regard new donor acquisition as an investment, and the initial campaign expense would be spread out over the useful lifetime of the investment (i.e., as long as newly-acquired donors continue to give). If this were done, both the net returns from fundraising and the fundraising share would be much lower in the first year, and slightly higher over the remaining years. Nonprofit accounting rules improperly prohibit such allocations, artificially inflating costs in the early years.

Second, solicitation attracts more than dollars. Campaigns can attract new

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23. (no author listed), "Donors and Dollars: Investing in Direct Mail Fund Raising," Burlington, Mass.: Epsilon Data Management, Inc. (Pamphlet), 1978.

volunteers, whose value should be computed into the net returns. In-kind contributions should be similarly included. Finally, solicitation doesn't just raise resources for the provision of charitable purposes; sometimes the solicitation process provides the charitable service as a costless by-product. For example, charities which seek to educate the public combine education with requests for funds in their solicitation literature. If so, a dollar spent on solicitation may add to charitable output even if no donations result.

Even if public education is not one of the charity's goals, the public is educated about the charity through the solicitation process, and this information is not valueless.<sup>24</sup> A similar (although exaggerated) sentiment was expressed in an analysis of advertising by for-profit firms:

"It is sometimes useful to view advertising supplied by firms as part of the product itself. After all, firms do supply the goods and services consumers demand. It is doubtful that anyone objects to Hershey's selling wrappers with chocolate bars. The wrapper is part of the product. Consumers of chocolate want wrappers and are willing to pay for them if it benefits them. So too with advertising, although in a somewhat indirect fashion. Additional information about a product may be viewed as part of the product."<sup>25</sup>

#### B) Fraud as the Capacity or Tendency to Deceive

Even 'fraud' may be protected free speech under the First Amendment.

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24. Although this incidental education is not valueless, its value to the public is generally less than its cost to the charity. When services are bought voluntarily, we can be sure their value exceeds their cost. Because solicitation is provided for free (indeed, the consumer may have to go out of his way to avoid being solicited), no such guarantee applies to incidental education.

25. Robert B. Ekelund, Jr., and David S. Saurman, Advertising and the Market Process at 59, 1988.

Evolving case law suggests that the extent of protection depends upon the type of speech. Vern Countryman<sup>26</sup> suggested four relevant categories: political speech, which can only be regulated if the speech presents a "clear and present danger"<sup>27</sup> of provoking illegal action; religious speech, where the government may challenge a defendant's good-faith belief in an asserted religious doctrine but may not challenge the truth of that doctrine<sup>28</sup>; cultural speech, judged for obscenity under the muddle of local community standards; and commercial speech, which receives limited protection under the Constitution.<sup>29</sup> For commercial speech, the consumer protection standard applied by the FTC is that advertising is impermissibly misleading if it has the capacity or tendency to deceive an ordinary man of common intelligence.

Under the vague, and sometimes conflicting holdings in *Schaumburg*, *Munson*, and *Riley*, one suspects that a fifth category of free speech protection is evolving for charitable solicitation. At some points, the Court speaks of permissible regulation through vigorous enforcement of state anti-fraud laws, preventing professional solicitors from "obtaining money on false pretenses or ... making false statements"<sup>30</sup>.

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26. Vern Countryman, "Advertising is Speech," in Allen Hyman and M. Bruce Johnson, eds., Advertising and Free Speech, 1977 [hereinafter *Free Speech*] at 43-44.

27. See *Bradenburg v. Ohio*, 395 U.S. 444 (1969).

28. See *U.S. v. Ballard*, 322 U.S. 78 (1944), which concerned prosecution for using the mails to defraud by soliciting funds for an alleged religious movement.

29. To be upheld, regulation of commercial speech must serve a substantial government interest, must directly advance that interest, and cannot be more extensive than is necessary to serve that interest, according to *Central Hudson Gas and Electric v. Public Service Commission*, 447 U.S. 557, 561 (1980).

30. *Riley*, 108 S. Ct. at 2679.

However, these laws have been designed to regulate less-protected commercial speech, and the Court has made it clear that a higher standard applies to charitable solicitation.<sup>31</sup> One wonders whether anti-fraud statutes would often be upheld in light of the Court's statement that "[b]road prophylactic rules in the area of free expression are suspect"<sup>32</sup>. The FTC rule may well fit into the proscribed category for charitable solicitation. Although the Court sometimes seems to suggest that charitable solicitation falls within the highest category of protection,<sup>33</sup> it seems less protected than political speech. Can anyone imagine (except in their partisan daydreams) the prosecution of political candidates under state anti-fraud laws? On the

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31. For example, in *Schaumburg*, the Court stated:

"[C]haritable appeals for funds ... involve a variety of speech interests - communication of information, the dissemination and propagation of views and ideas, and the advocacy of causes - that are within the protection of the First Amendment. Soliciting financial support is undoubtedly subject to reasonable regulation but the latter must be undertaken with due regard for the reality that solicitation is characteristically intertwined with informative and perhaps persuasive speech seeking support for particular causes or for particular views on economic, political, or social issues, and for the reality that without solicitation the flow of such information and advocacy would likely cease."

444 U.S. at 632. In *Riley*, the Court stated:

"The First Amendment mandates that we presume that speakers, not the government, know best both what they want to say and how to say it."

108 S. Ct. at 2672-2676.

The Court has refused to allow the separation of 'commercial' from 'informative' or 'advocative' speech when solicitation is involved, asserting that:

"[W]e do not believe that the speech retains its commercial character when it is inextricably intertwined with otherwise fully protected speech."

*Riley*, 108 S.Ct. at 2677.

32. *Riley*, 108 S.Ct. at 2679-80 (quoting *NAACP v. Button*, 371 U.S. 415, 438 (1963)) The Court continued: "[p]recision of regulation must be the touchstone in an area so closely touching our most precious freedoms." (ibid)

33. Solicitation is "fully protected speech." *Riley*, 108 S.Ct. at 2677.

other hand, solicitation by religious charities receives the additional protection accorded religious free speech, which is nearly total. Although the claim that God would call Oral Roberts home if contributions were insufficient was not based on carefully controlled scientific studies (much to my disappointment), this claim cannot be challenged as misleading or fraudulent. In sum, except for religious solicitation, it is unclear whether states can constitutionally prosecute charities for allegedly fraudulent misrepresentations. I argue below that when prosecution is permissible, the FTC standard is overly broad on policy grounds.

Often, potential donors are not only unaware of the characteristics of a particular charity - they are unaware that they would like to know these characteristics. In such cases, strictly informative advertising would be ignored by those who would benefit from it. The critical prerequisite to successful communication is to get the donor's attention, and this requires some imaginative 'irrelevancies.'<sup>34</sup>

Once this is understood, solicitation messages can be viewed in a different light.

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34. Talking about advertising more generally, Israel Kirzner wrote:

"[P]otential consumers may be ignorant concerning the potential usefulness to them of known available commodities - and may, to boot, be ignorant of their ignorance in this respect as well ... [C]ustomers who are unaware that they lack vitally important information are in no obvious way motivated to acquire that information - even if it is made costlessly available to them. It is necessary for the producer to grab the attention of his prospective customers and somehow to get them to see the ... information available concerning such products. ... To grab a consumer's attention may just possibly be to do something for which that consumer will be eternally grateful even though, at the moment, it appears to violate his own expressed preferences." (emphases in original)

"Foreword" in Ekelund and Saurman, supra note 25, at xviii and xx.



Transparent lies are sometimes included as attention getters, to amuse the intelligent reader rather than to fool the gullible (witness the recent series of ads by Isuzu, which celebrate fraudulent dealer misrepresentations about the very car being advertised).

Commenting on FTC regulation of allegedly fraudulent advertising of products, Philip

Nelson wrote:

"Hyperbole plays a useful role in advertising. Exaggeration makes advertising more memorable. The more memorable advertising, the more efficient it will be from both a private and a social point of view, simply because memorability makes advertising perform its information function better. The FTC seems bent on eliminating these exaggerations. Take, for example, the famous case of the sandpaper shave. The FTC ruled that Rapid Shave must cancel this advertisement on the grounds that the conditions of the experiment were not quite kosher. An exceedingly memorable advertisement was eliminated; I believe virtually no new source of direct information was opened up by this decision."<sup>35</sup>

Consider, for example, the 'charitable sweepstakes' which inform potential donors that they have won something, that they need not donate to collect their prize (although their altruism would be appreciated), and that some of the prizes are quite large. Although it has been asserted that these sweepstakes have the intent to deceive the recipient into the belief that she has won a large prize which she will be unable to collect without making a sizable donation, its my guess that few donors are fooled. Those who are fooled quickly learn of their mistake when they try to collect, and would not repeat their mistake. Generally, their only losses are the disappointment of dashed expectations and the making of a larger-than-otherwise donation.

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35. Philip Nelson, "Comments on Advertising and Free Speech," in *Free Speech*, supra note 26 at 55.

My own reaction to these sweepstakes is to carefully read every word, looking for the trick. In so doing, I inadvertently read every word written about the need to help the sponsoring charity, and I suspect I am not the only consumer to respond this way. These sweepstakes continue not because charities obtain sizable profits from those who are 'fooled', but because they attract the attention of jaded consumers, some of whom are moved to contribute.

The case for government regulation of claims made by solicitors must rest upon the general superiority of the government in evaluating these claims. When claims are objective, the government may have a cost advantage in determining their truthfulness. Thus, one government audit can verify financial representations by solicitors and certify truthfulness to all potential donors. Without government, either individual donors would have to undertake redundant audits or they would have to organize a private certification agency which might not have government's credibility.

However, much of the concern over charitable misrepresentations concerns subjective claims. The government has little advantage over individual consumers in determining the validity of these claims, for what is 'fraudulent' to one consumer may be 'vital information' to another. Perhaps this is what the Founders had in mind when passing the First Amendment<sup>36</sup>

### III. COSTS OF MISGUIDED CONTROL EFFORTS

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36. Thus, the majority in Riley argued that "[f]ree and robust debate cannot thrive if directed by the government. We perceive no reason to engraft an exception to this settled rule for charities." 108 S.Ct. at 2675.

So far, little has been said that hasn't been said before. Fundraising share provides no information which could aid authorities in detecting fraud. My contribution below is to analyze the social costs of proceeding on the mistaken premise that share is relevant, either in conducting public information campaigns, in selecting cases for prosecution, or in denying tax exemptions to high-share charities. I also consider the undesirable side-effects of other regulatory efforts.

#### A) Compliance and Regulatory Costs

If the goal of fundraising regulation is to enhance 'pass-through rates,' it hardly helps matters to mandate the diversion of funds to excessive audit fees, bonding costs, and, when prosecution is threatened, legal fees. Additional government mandates in the area may indeed be desirable, but the costs must be weighed against the benefits. Bonding and auditing are already employed whenever (and to the extent that) they enhance the receipt of donations. Unlike money diverted to additional solicitation, money spent on audit and bonding fees is entirely diverted from the provision of charitable services. Henry Suhrke noted:

"[T]he costs and benefits of any complex reporting system ought to be considered ... [A]s in most areas of law enforcement, given no particular evidence to indicate wrongdoing, it is not efficient to penalize a whole constituency with costly red tape and filing requirements."<sup>37</sup>

The proposal to condition tax exemption on maintenance of a low fundraising share would also lower pass-through rates whenever high shares result from events which are not under the charity's control or when it is in the charity's interest to

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37. Henry Suhrke, "State Governments Revise Fundraising Laws," Philanthropy Monthly, July/August 1989, at 6-7.

maintain a high share (in order to maximize net returns) despite the tax penalty of doing so. It is particularly ironic that those donors who are looking towards charity as an alternative to tax-mediated government provision of services would then see their donation diverted to tax payments.

Although public regulation may have benefits, government costs must be weighed against these benefits. The tradition of financing legal investigations from fines collected from wrong-doers or registration fees and excise taxes imposed on the regulated charities does nothing to mitigate these costs. Money spent by the government on enforcement is money that cannot be spent on other valued government purposes (including social programs, defense, or even deficit reduction), and the value of money does not depend in any way upon its source.

The state of Florida has recently implemented an enlightened policy, given the reality of current state priorities. Recognizing that it is no longer permissible to identify high shares with fraud, and that it makes no sense to require detailed financial and other statements if the state is not willing to provide the resources to thoroughly investigate these statements for evidence of real fraud (such as private inurement), the state has abolished all registration, fee, reporting, and bonding requirements for charities and fund raisers.<sup>38</sup> The state penalizes wilful failure to maintain adequate records or disclose such records when requested, but otherwise requires no routine reporting. Suhrke feels that other states should follow Florida's lead:

"In fact, most States that required registration and financial reporting did almost

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38. *ibid.*

no analytical work on the reports filed, except for selective attention to types of fundraising that might incur high fundraising costs. However, the kind of analysis which would uncover fraud - such as private inurement from charitable funds - was, with the exception of just a handful of states, not undertaken."<sup>39</sup>

#### B) Misleading Advertising and Misled Donors

Honest, low-pressure, nonintrusive fundraising techniques can be less cost-effective (at least in the short run) than misleading, high-pressure, and intrusive tactics. Absent pressures to keep fundraising share low, nonprofit boards can safely select their preferred style of fundraising. If authorities burden the board with pressures to cut fundraising shares, the temptation to compromise propriety might become irresistible. Fundraising counsel would be selected based on past financial success, and the board wouldn't really want to ask too many questions about how that success was achieved. In a sense, real 'fraud' would be increased by this misguided fight, and this is the sort of fraud which is unlikely to lead to successful prosecutions.

One form of this potential abuse is deception through multiple targeting. Brian H. Smith supplies an example:

"In the early 1980s Oxfam Belgium, for example, had 20,000 donors, 2000 of whom committed themselves to giving 1 percent of their annual income to the organization. This smaller group ... knows very well that the organization is supporting groups sympathetic to the PLO in the Middle East and the Polisario movement in the western Sahara. The other 90 percent receive only general reports. ... Their prime motive in contributing is to further self-help socioeconomic development among the Third World poor, not to promote radical political change abroad, and their impression is that Oxfam Belgium is doing the first but not the second. ... As a result of such multiple appeals, Oxfam Belgium almost doubled its resources ... precisely at the time when Belgian government subsidies to the organization were gradually declining

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39. *ibid.*

because of its controversial activities."<sup>40</sup>

The activities of Oxfam Belgium would not constitute fraud by any legally-enforceable definition, and yet donations are clearly obtained from misled donors. Under the pressures of financial stringency, some misleading multiple targeting occurs now but other boards resist the temptation. Proposed fundraising reforms would lower their resistance.

Second, restraints on fundraising share would, absent explicit prohibition, increase the use of accounting tricks to make share seem lower than it is. These tricks would involve misallocation of joint costs - costs incurred because of a combination of activities which differ from the costs of the activities conducted separately. For example, the costs of a solicitation message which combines public education with a call for funds should be allocated partly to fundraising and partly to service provision. If all of the costs are allocated to service provision, reported fundraising costs are artificially low. Other examples are provided when a college president involves himself with alumni. The president's salary then reflects both service provision and fundraising costs, and the accounting allocation should be split between these two categories. Finally, many nonprofits are essentially commercial, selling a product which they advertise. Joint costs may be incurred when requests for donations accompany advertisements for sale of a product, and these costs should be allocated among fundraising and cost of goods sold.

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40. Brian H. Smith, "More than Altruism: The Politics of European International Charities," in Estelle James, ed., The Nonprofit Sector in International Perspective, 1989, at 328-9.

Accounting tricks such as these are already employed on occasion, but some organizations view them as what they are and avoid them. If fundraising shares were regulated or advertised by the government, these organizations might not be able to afford the luxury of their honest reporting, and a mild form of fraud would increase.

The government could prevent this form of fraud by prescribing accounting rules. For example, Senator Metzenbaum's bill requires 100 percent allocation to fundraising for the cost of any mailing which mentions a request for funds. The problem with enforceable accounting rules is that they tend to lack sufficient flexibility to truly account for costs, as illustrated by Metzenbaum's proposal to mandate the substitution of one mistake (100 percent allocation of joint costs to fundraising) for another (excessive allocation to costs of service). Donors are no better informed, and the rules have unintended efficiency costs, discussed below.

Third, enforcement and publicity campaigns could provide the donor with a false sense of security. Fraud does not prosper unless there are victims willing to be misled. Absent vigorous anti-fraud efforts by the public sector, donors take care to personally investigate prospective recipients of their largesse. Although (in full context) he does not view anti-fraud laws regulating advertising more generally as "pointless", Philip Nelson explains this shortcoming thusly:

"The circumstances under which advertisers have the greatest incentive to deceive if consumers believed them are precisely the circumstances under which consumers would be least inclined to believe advertising. Deception requires not only a misleading or untrue statement, but somebody ready to be misled by that statement. ... The more the law protects against fraud, the more people think the law protects against fraud. Misinterpretation of the law's domain will exist, no matter how extensive that domain. Indeed, I believe, there is probably more deceptive advertising given laws on fraud than without

them."<sup>41</sup>

One consequence of a false sense of security is that volunteering may decrease marginally. One of the motives for volunteering is to acquire information about the merits, efficiency, trustworthiness, etc. of a charity prior to committing financial donations<sup>42</sup>. Donors who believe that the government has already insured efficiency and trustworthiness will no longer need to volunteer to confirm this for themselves. This decline in volunteering would hardly hurt the average charity however, as improved donor confidence would probably result in more-than-compensating increases in monetary donations.

'Bad' charities would be inappropriately rewarded by a false sense of donor security, but 'good' charities would also be rewarded where this sense of security was justified. In light of the general insufficiency of charitable donations (discussed below), this increase in 'fraud' (as donors become overconfident) may actually count as a benefit of regulation.

### C) Inefficient Generation of Donations

Donations are inefficiently generated if it is possible to generate the same level of donations with lower resource costs or, conversely, to generate more donations with the same resource costs. Share restrictions (or publicity) are presumably aimed

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41. Nelson, supra note 35, at 54.

42. See Jerald Schiff, Charitable Giving and Government Policy: An Economic Analysis, 1990, at 50-53.



at enhancing efficiency, but they would be counterproductive for several reasons. First, volunteer labor and volunteered resources would be inefficiently diverted to fund raising. Some volunteers are well suited to fund raising, others are not. With restrictions on share, every available volunteer would be shifted to fund raising, for the accounting cost of volunteer time is zero. Although this diversion would decrease fundraising share as measured by conventional accounting methods, it would increase the resource cost of fundraising. Similarly, if a phone bank were contributed by the local phone company, the charity would use telemarketing (with low accounting cost) even if alternative fundraising techniques would be more efficient.

A numerical example makes this point clearer. Suppose that a charity could hire a professional fund raiser for \$20,000 who, because of his professional training, would raise \$100,000. As a result of this transaction, the charity would come out ahead by \$80,000, and would have a 20 percent fundraising share. Alternatively, the charity could pay \$1,000 to attract and retain several volunteers, who, because of inexperience and lack of training would only be able to raise \$10,000. The charity's net gain from this alternative is only \$9,000, so clearly the charity would prefer the professional fund raiser. Yet, the former alternative has a much lower fundraising share (10%), and might be selected under the pressure of regulation or publicity.

Second, regulations or publicity would force charities to inefficiently spread out their new donor acquisition campaigns. Of course, shares are quite high for new charities (as conventionally measured, that is, without spreading acquisition costs over the lifetime of the investment), and many regulatory proposals exempt charities for

the first few years of their life. However, new opportunities and new directions may arise at any time during the charity's existence, so that a massive donor acquisition campaign may be warranted down the road. Restrictions on share would preclude such a campaign, and charities would be forced to mix a small donor-acquisition campaign with the regular call for continued support for many years thereafter. Both because new donors renew their donations year after year and because money today is more valuable than money tomorrow, this mandated delay in new donor acquisition reduces the efficiency of donation production.

Some of the mandated accounting rules proposed would also reduce efficiency. For example, Senator Metzenbaum's proposal means that charities which seek to educate all of the public as well as raise donations must send two separate mailings. The nearly costless line at the bottom of an educational or advocative mailing requesting contributions would, under his bill, mandate labelling the entire costs of the mailing as 'fundraising,' greatly increasing reported share (which would decrease donations, hence lower efficiency). Share would not be increased if requests for contributions were absent from educational material, but then costs would go up (for a second, narrowly targeted solicitation request) and donations would go down (as some potential donors outside the target group are never reached). Both these factors hurt efficiency. Special considerations apply when regulations attempt to restrict or publicize contractually-obligated fundraising shares (shares of net receipts obligated to fund raisers under incentive-payment plans). This disclosure of incentive contract provisions impairs efficiency because it enables donors to better promote

their individual interests to the detriment of donor-class interests, reducing the net funds obtainable from solicitation.

If nonprofits rationally choose to employ incentive payment plans, it must be that the gain in contributions resulting from enhanced effort by solicitors exceeds the loss in the share of contributions retained for charitable purposes. As noted above, it is in the interest of individual donors to ignore incentive effects, although donors as a whole benefit from these incentive plans.

If donors are made aware of the diversion of funds, they will reduce their contributions, causing a reduction in the provision of charitable services.<sup>43</sup> Yet, the conflict between individual and group incentives is clear. Faced with a choice between revealing to every donor that funds are diverted or revealing this fact to no donors, each donor would prefer the latter. Donors are willing to accept their ignorance in the matter because if other donors are similarly ignorant, each donor benefits from the increased provision of charitable services.<sup>44</sup>

The situation is quite different from the standard case of consumer protection. In a one-on-one negotiation with a seller, a consumer prefers to be fully informed about the terms of trade. Whether other buyers are also fully informed has no effect

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43. Faced with information revelation, the nonprofit might decide against employing incentive contracts. The donor class is hurt by this donee decision (relative to how they would feel if the donee used an incentive contract but did not reveal this fact to donors). Thus, donors are hurt by the prospect of revelation, regardless of whether the donee continues to employ incentive contracts or abandons this contractual form.

44. I am indebted to Estelle James for this point, which she presented in another context.

on our given consumer. In contrast, donations finance a public good (one that can be simultaneously enjoyed by various consumers), so that information provision, which alters the behavior of other donors, is detrimental to each individual donor.

It is well-known that public goods are typically under-financed (hence under-provided) when there is sole reliance on voluntary donations. The so-called free-rider effect results when individual donors weigh their sense of obligation against the personal gains to letting someone else pay for the good. The under-provision problem is exacerbated when contractual fundraising shares are publicized because of state action. A similar problem may apply to compelled status disclosures.

There is no ideal solution to the free-rider problem. The state's typical solution is to finance public goods through mandatory taxes, so that all beneficiaries are forced to pay something (although the relation between individual benefits and tax shares is somewhat tenuous). Voluntary donations are non-coercive, but face free-rider problems. Non-publicized incentive contracts are a partial solution to the free-rider problem, and if consumer information under this alternative is less than perfect, this may be an acceptable price to pay when the alternative is state coercion.

A similar problem arises if shares are not contractually obligated, but donors nonetheless regard high average shares as evidence that their incremental donations will be diverted from service provision<sup>45</sup>. In this case, state-sponsored publicity about

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45. This sort of assumption was made in Susan Rose-Ackerman, "Charitable Giving and Excessive Fundraising," 97 Quarterly Journal of Economics 193. Empirical studies support varying conclusions about the descriptive significance of this assumption. In Should Donors Care, supra note 2, I found that although the level of fundraising determined the

(continued...)

shares would also exacerbate the free-rider problem, although the source of the problem is a bit different. Net donations would be lower both because of adverse donor reaction to the information about fundraising share and because of the charities attempt to minimize the damage by cutting otherwise-productive solicitation expenditures.

There is one problem caused by fundraising which share regulation could ameliorate. To some extent, fundraising by one charity enlarges the total amount of donations received by all charities, but to some extent, fundraising by one charity comes at the expense of others. Competing charities will have lower efficiency in fundraising, for they would have to increase their solicitation expenditures just to hold donations constant. This problem was analyzed by Rose-Ackerman<sup>46</sup>, who carried it to its logical extreme. If entry of new charities occurs whenever there are potential net gains from fundraising, then in the limit fundraising is strictly

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45. (...continued)  
level of donations, various measures of fundraising share had no significant effect. In contrast, two studies (Burton A. Weisbrod and Nestor Dominguez, "Demand for Collective Goods in Private Nonprofit Markets: Can Fundraising Expenditures Help Overcome Free-Rider Behavior?," 30 Journal of Public Economics 83, 1986; John Posnett and Todd Sandler, "Demand for Charity Donations in Private Non-Profit Markets: The Case of the U.K., 40 Journal of Public Economics 187, 1989) found that measures of fundraising share exerted an independent negative influence on giving. Posnett and Sandler acknowledge my theory on incremental vs. average shares, but dismiss it as too sophisticated for the average donor, a point on which I am tempted to agree. However, as donors are currently ill-informed about fundraising proportions, they cannot employ this data as an unsophisticated rule-of-thumb decisionmaking tool. I therefore suspect that those statistical results in both studies that differed from mine are artifacts, although the matter remains unresolved. The situation might be different if public authorities publicized fundraising shares.

46. *ibid.*

competitive - each charity receives a vanishingly small amount from its campaign, and yet campaigns are necessary for survival, so that fundraising appears, at first glance, to be a pure waste. However, in her model (as in reality), fundraising provides information as well as financial resources, and the value of information in the limit was not analyzed in her paper. In addition, realistically speaking, entry is much more limited than that, so that fundraising by one firm has only a small effect on the efficiency of solicitation at other firms. Nonetheless, if these 'tragedy of the commons' style interactions became important, fundraising share restrictions might be helpful in limiting entry and hence competition for potential donations.

#### D) Inefficient Provision of Charitable Outputs

Charitable outputs are efficiently provided if there is no way to increase service provision from given resources or, conversely, there is no way to produce the same level of charitable output using fewer resources. Restrictions on publicity on fundraising share impairs a charity's efficiency in providing service two ways - by promoting inefficient input combinations and by reducing the spur to efficiency provided by competing charities. Each of these arguments is considered in turn.

The first argument is the flip side of the argument presented in a previous section of this paper, that share regulation encourages charities to misallocate volunteered and donated resources to fundraising even when the volunteers would be more efficient at providing service. Both the efficiency of fundraising and the efficiency of service provision are hindered by this misallocation.

More generally, efficiency will suffer if managers lose flexibility as a side-effect of the regulation. If fund raisers are mandated to disclose the percent of anticipated (or of last year's) revenues to be devoted to each charitable purpose, to fundraising, and to administration, then managers will feel that if they depart from these percentages, their charity risks prosecution for fraud. In effect, managers are restricted to linear allocation rules.

Linear allocation rules are inefficient, in part, because they imply the loss of ability to prioritize expenditures. If donations are expected to be low, the charity may announce that it will spend primarily on its highest priority program. If donations then turn out to be higher than expected, the charity would be inhibited from diverting the unexpected surplus to the second priority program because if it did, the share devoted to the highest priority would differ from the announced plan. Conversely, if revenues are expected to be high, so that the charity announces its intention to fund both priorities, then actual revenues turn out to be low, the charity cannot shift funds to make up for losses in its top priority program without risking prosecution for fraud.

In particular, if contributions are lower than expected, fundraising expenditures would have to be cut to stay within announced shares (assuming that fundraising this year brings donations next year, and the share restraint is enforced on an annual basis). This is exactly the opposite of what the charity should do if incremental fundraising is sufficiently productive.

Charity managers and boards of directors are often well-motivated to efficiently

provide services desired by donors and recipients, but the evolutionary forces insuring against the survival of incompetent or ill-motivated managers are somewhat weaker than they are in the for-profit sector. Poorly run charities are rarely subject to hostile takeover bids by those who could profit from running the charity better because the nondistribution constraint removes both the incentive (financial gain) and the means (stock purchases) to accomplish a takeover.<sup>47</sup> More important than actual takeovers is the threat of a takeover. Absent serious threats, charities do not need to implement pro-active efficiency measures to forestall takeover bids.

In the for-profit sector, competition also impels efficiency. If a firm is inefficient or fails to respond to customer needs, it is driven out of business by more effective firms. Among nonprofit organizations, competition is the chief (and perhaps only) external stimulus to efficiency. Competitors must also be nonprofit organizations, because for-profit competitors are relatively disadvantaged under current tax and regulatory policies. An inefficient nonprofit could effectively compete with an efficient for-profit, financing its inefficiency through tax breaks and donations.

In turn, solicitation and other forms of advertising are prerequisites for effective competition. Restrictions on fundraising may decrease efficiency by eliminating the

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47. Takeover bids are logically possible for what Hansmann has called 'mutual' nonprofits - those where the power to select the board of directors resides with the organization's patrons (donors and customers). Such bids could be accomplished by stacking the electorate. In contrast, 'entrepreneurial' nonprofits - those where the power to select the board lies with others, including the case of self-perpetuating boards, would seem to be generally immune from takeover.



spur provided by effective competitors.<sup>48</sup> For example, imagine that a group of entrepreneurs believed that the American Cancer Society (ACS) had become too ossified in selecting priorities for research, both internally, and, through interlocking advisory boards, for federal research funding. This group could found an alternative health research fund to finance neglected but promising avenues of research, but to attract any donations, they'd have to advertise very intensively for several years. The new charity would, of necessity, have a very high fundraising share for they would have to convince the public that an enormous, well-respected, and established charity had become misguided.

In this example, it is not very important whether the alternative charity succeeds, in the long run, in attracting sufficient donors to finance a research program with a low fundraising share. The key is that the competitive threat posed by such upstarts would keep ACS on its toes, constantly re-examining its efficiency in meeting patron needs. Long-run survival would dictate a pro-active and efficient management for ACS. And who knows? Perhaps the neglected research avenues would prove fruitful, assisting in the treatment of cancer cases. Regardless, competition would improve performance; competition that would be precluded if fundraising shares were restricted.

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48. Competition among nonprofits is usually helpful, but there are some cases where it may hurt efficiency. The issues are far from fully-developed and understood in the economics literature. I provide a preliminary discussion in my paper "Antitrust and the Nonprofit Sector," (draft) July, 1990. To the extent that competition among nonprofits reduces, rather than enhances efficiency, my arguments in the text must be reversed. Thus, if fundraising promotes competition and competition is bad, the case against regulation is weakened.

Much of the existing analysis of advertising by for-profit firms is instructive here. The early literature viewed advertising as anticompetitive, but recent models come to the opposite conclusion. For example, Kessides<sup>49</sup> has developed a mathematical model in which advertising plays two roles. Advertising gives incumbent firms an advantage over potential entrants in that entrants will have to invest heavily in advertising during the initial years to alert potential customers who are already comfortably versed in the merits of the incumbent's product. However, advertising also reduces the risk that the new venture will fail, with consequent loss of the other sunk costs of entry. On balance, advertising encourages the entry of competitors. In a similar vein, Brozen<sup>50</sup> argues that restrictions on advertising make it more costly for firms to let consumers know that a new supplier is in the market. They must resort to more costly methods of conveying this information, and consumer prices are higher as a result.

Several studies confirm this general pattern. Boddewyn<sup>51</sup> noted that prior to the ban on television advertising of cigarettes in 1970, an average of one new brand per year was introduced. During the studied period following the ban (1970-74) no

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49. Ioannis N. Kessides, "Advertising, Sunk Costs, and Barriers to Entry," 68 Review of Economics and Statistics 84, 1986.

50. Yale Brozen, "Competition, Efficiency, and Antitrust," The Competitive Economy, 1975.

51. J.J. Boddewyn, "Tobacco Advertising in a Free Society," in R. Tollison, ed., Smoking and Society, pp. 309-32.

new brands were introduced. A study by Benham<sup>52</sup> compared the price of eyeglasses in states that did not allow advertising in 1963 with the price in other states. After controlling for several other determinants of price, Benham found that a statistically and numerically significant price differential remained; advertising lowered prices. A subsequent study<sup>53</sup> examined the effect of ethical codes which declared that advertising professional superiority, wider range of services, or lower fees was unethical and unprofessional conduct. Again, in states where a greater share of optometrists belonged to organizations which enforced such codes, the price of eyeglasses was substantially and significantly higher. Similar results were found for the advertising of prescription drug prices<sup>54</sup> and for the billboard posting of gasoline prices.<sup>55</sup> Finally, an FTC study<sup>56</sup> found that commercial optometrists (those that advertise heavily) provided statistically significantly better-fitted hard contact lenses than noncommercial optometrists. Apparently, advertising both lowers price and improves quality, as one would expect if it fostered efficiency-enhancing competition.

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52. Lee Benham, "The Effect of Advertising on the Price of Eyeglasses," 15 Journal of Law and Economics 342, 1972.

53. Lee Benham and Alexandra Benham, "Regulating through the Professions: A Perspective on Information Control," 18 Journal of Law and Economics 421, 1975.

54. John F. Cady, Restricted Advertising and Competition: The Case of Retail Drugs, 1976.

55. Thom Kelly and Alex Maurizi, Prices and Consumer Information: The Benefits from Posting Retail Gas Prices, 1978.

56. Gary D. Hailey, Jonathan R. Bromberg, and Joseph B. Mulholland, "A Comparative Analysis of Cosmetic Contact Lens Fitting by Ophthalmologists, Optometrists, and Opticians," Report of the Staff of the Federal Trade Commission, 1983.

The courts have recognized the value of advertising in fostering competition in many recent cases. For example, the Court invalidated the Arizona State Bar's restrictions on advertising by lawyers, rejecting arguments that attorney advertising is inherently misleading, would increase the cost of doing business, increase entry barriers to new attorneys, and drive up the prices of legal services<sup>57</sup>. Ethical codes which required that accountants charge fixed fees, rather than work on a commission basis, have been invalidated under antitrust statutes<sup>58</sup>. Faced with similar prosecution, the major associations of fund raising counsel have removed similar proscriptions from their codes of ethics<sup>59</sup>. While it may be a good thing to eliminate these proscriptions<sup>60</sup>, it is indeed ironic that at the same time that self-regulation has been restricted under the threat of prosecution for antitrust violations, proposals seek to impose those same restrictions through state action.

#### E) Inefficient Provision of Information

Clearly, one of the useful outputs provided as a by-product of solicitation is

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57. *Bates v. State Bar of Arizona*, 433 U.S. 350 (1977).

58. The American Institute of Certified Public Accountants signed a consent decree with the FTC in March 1989. See, i.e., Kristin A. Goss and Wendy Melillo, "Vote to End Ban on Commission Payments Stirs Ethics Debate Among Fund Raisers," 1(14) The Chronicle of Philanthropy 1, at 12 (May 2, 1989).

59. *ibid.* See also Larry Sterne, "NSFRE Deletes Ban on Soliciting for a Percentage," 3(2) The Nonprofit Times 1 (May 1989).

60. Especially in light of the findings of Benham and Benham discussed above. The issues for fundraising by nonprofits are considerably more complex, however. See Steinberg, "Profits as Incentives...", supra note 19 for an analysis of the reform of these codes.

information - information that a charity exists, information about the goals, means, and efficiency of the charity, information about the qualities and prices of products sold, and, in some cases, misinformation about any of these. Information has value, but the dissemination of information has costs (especially when truthful and misleading messages are inextricably intertwined). Trading off the benefits and costs, one expects an optimum in which not every potential donor is fully informed. Restrictions on fundraising probably reduce the equilibrium level of information provision, but, in light of the optimality of incomplete revelation, it is not obvious whether this is a good thing or a bad thing.

The argument has not been well-developed in the literature on fundraising, in large part, because such modelling as has occurred for advertising by for-profit firms has been so inconclusive. Advertising can play many alternative roles. In some roles, the existing literature suggests that too much advertising is provided, in others, that too little is provided (relative to the optimum). One's overall assessment of advertising then depends upon the relative importance of the various roles played, which has not been conclusively studied for for-profits, and has hardly been studied at all for nonprofits.<sup>61</sup>

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61. One exception is Rose-Ackerman, *supra* note 45, who assumed for modelling purposes that donors only learn of a charity's existence if they receive a brochure from that charity, and that the brochure truthfully reports the charity's 'ideology,' level of service in the previous period, the cost of adding an additional client, and the fundraising share. The empirical validity of these assumptions is not important for her purposes, but would be important if we sought to develop a comprehensive evaluation of fundraising. Another is Weisbrod and Dominguez, *supra* note 45, whose model is similar to that of Ehrlich and Fisher, discussed below.

For example, Usher summarizes the implications of six alternative proposed models of advertising (neglecting several other extant models).<sup>62</sup> He shows that if the only role of advertising is to inform consumers that a product exists, there is too little advertising in a free market. In this case, measures to restrict advertising expenditures would worsen the problem. The same conclusion emerges if advertising serves to associate a product (in the mind of the consumer) with happiness or success, thereby making the product more desirable. If advertising not only associates the advertised product with success, but also disassociates a competing product with success, advertising in a free market is generally excessive, so that a properly-structured restriction might help. If advertising makes one believe that a product sold by a monopoly has certain properties, but post-purchase experience reveals this belief to be incorrect, then advertising may be excessive or inadequate<sup>63</sup>, depending (in a specified way) upon the specific circumstances of the market in question. His other two models (one in which advertising is simply one good, valued by consumers, which is complementary to the financing of a public good and one in which the fact that it pays to advertise provides a quality signal to consumers) give similarly ambiguous results.

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62. Dan Usher, "Six Models of Advertising Welfare," Discussion Paper #756, Queen's University, (revised) July 1989.

63. Monopolies tend to under-provide goods; the 'false preference' induced by advertising causes the firm to want to sell more, so that even though purchasers are fooled, they might end up purchasing the proper quantities, as they would in perfectly competitive markets.

Usher's six models are analogous to fundraising by nonprofits. For example, solicitation may inform the donor of the charity's existence, associate a donation with a sense of personal pride, denigrate donations to other charities, or fool donors into thinking they are getting something they are not<sup>64</sup>. All these models (and others) should be further developed and extended to fundraising by nonprofit organizations to provide a complete assessment. I have a much more modest goal, and will discuss only the Ehrlich and Fisher model<sup>65</sup>.

In this model, consumers are imperfectly informed about the qualities of competing products. Consumers make their purchase decisions based on the full price of the good, which includes the posted, or nominal price plus the costs of obtaining the information necessary to decide on the purchase. Firms advertise because by providing information through this means, they can lower search costs and hence the full price faced by consumers. In turn, at a lower full price, consumers are willing to increase their purchases by enough to more than cover the costs of providing the advertising. Ehrlich and Fisher conclude that advertising is socially efficient in that it minimizes the full price paid by consumers. Restrictions on advertising, in this context, reduce the efficiency of information transmission and acquisition.

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64. Just as monopolies under-provide goods, donations are under-provided due to free-rider problems. Thus, as in Usher's fourth model, fraud may be helpful in mitigating the under-provision problem.

65. Isaac Ehrlich and Lawrence Fisher, "The Derived Demand for Advertising: A Theoretical and Empirical Investigation," 72 American Economic Review 366, 1982.

Most of the cited papers on fundraising view fundraising share in terms of its effect on the donor's price of giving. Thus, to a first approximation, naive donors might regard the price (out-of-pocket sacrifice) of a dollar's worth of charitable service as inversely proportional to fundraising share, for if a greater share of donations are diverted to fundraising, then a larger out-of-pocket expense is required to insure a dollar increment to charitable service provision<sup>66</sup>. Although I have criticized this measure above (noting that incremental diversions to fundraising are not the same as the average share), I have also recognized that donors might employ this measure as a crude rule-of-thumb. The insight of the Ehrlich and Fisher model can then be applied to this measure - restrictions on fundraising share might reduce the nominal donor price, but, by reducing the efficiency of information transmission, might increase the full price of giving.

#### IV) THE BETTER SOLUTION - THE NON-DISTRIBUTION CONSTRAINT

One suspects that underlying all the concern over excessive fundraising is the concern that someone is profiting at donor and charity expense. For example, in his dissent to Munson, Justice Rehnquist wrote:

"[Percentage limitations] insure that funds solicited from the public for a charitable purpose will not be excessively diverted to private pecuniary gain. In the process, they encourage the public to give by allowing the public to give

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66. Abstracting from tax considerations, this argument suggests that donor price should be defined as  $1/(1 - \text{fundraising share})$ . This is one of three increasingly sophisticated measures of price suggested by Rose-Ackerman, supra note 45, and criticized in *Should Donors Care*, supra note 2. All three cited empirical studies used variations of this measure.



with confidence that money designed for a charity will be spent on charitable purposes."<sup>67</sup>

Viewed in this light, restrictions on fundraising are redundant, trying to accomplish what the non-distribution constraint is directly designed to accomplish.

The non-distribution constraint is a term coined by Henry Hansmann to define the term 'nonprofit.'<sup>68</sup> He noted the common element in most state nonprofit corporation statutes and in IRS interpretations of organizations exempt from the federal corporate income tax, prohibiting not the making of profits but the distribution of profits to those in control of the organization. For example, tax exemption under section 501-(c)-(3) of the tax code (organizations organized and operated exclusively for religious, charitable, scientific, literary, educational, or similar purposes) is restricted to those organizations "no part of the net earnings of which inures to the benefit of any private shareholder or individual."

When the non-distribution constraint is effectively enforced, the incentive for abusing the fundraising process is largely removed. Thus, the best and most direct solution to alleged fundraising abuses lies in better enforcement of the non-distribution constraint. Campaigns conducted by nonprofit staff and volunteers should be carefully scrutinized for excessive compensation (higher than staff could obtain in its next-best employment position). Campaigns of any sort should be scrutinized for self-dealing (purchase of materials at excessive prices from a company

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67. Munson, 467 U.S. at 980 (Rehnquist, J., dissenting).

68. Henry Hansmann, "The Role of Nonprofit Enterprise," 9 Yale Law Journal 98, 1980.

owned by those controlling the campaign) and hidden payoffs.

The IRS has begun just such an investigation, requiring examined charities to fill out a 103-item questionnaire as part of a special emphasis program in this area<sup>69</sup>. Although some of the questions attempted to uncover fundraising share and other aspects which I have regarded as inappropriate, many were keyed to uncovering subtle forms of inurement. Here are some of the questions being asked:

17. Did the charity acknowledge receipt of the cash donation in writing?
23. Did the charity indicate in membership literature or other written evidence that the 'cost' of membership dues was tax deductible?
30. [If there was a contract with a professional fundraiser], was the compensation arrangement based upon a flat fee or as a percentage of the income generated by the professional fundraiser? Please describe the arrangement...
31. Was the charity created by an owner, officer, director, trustee, or employee of the professional fundraiser?
32. Is any officer, director, trustee, or employee of the charity employed by or connected with the professional fundraiser in any ownership of business, investment venture, or family relationship? [Explain].
35. Did the professional fundraiser have check 'cashing' authority?
48. Did the charity hire outside contractors to specifically operate bingo and other games of chance?
54. [If the charity conducted travel tours], Please indicate if the charity was related to the for-profit travel agency by means of (a) sharing the same address or building ... (c) creator of charity and owner of for-profit entity ... (e) presence of family ties ...
71. Who determined the Fair Market value of [any] contributed noncash property? [donor, charity, independent appraiser, other].
73. Was there any kind of an agreement between the charity and donor concerning the use, sale, or other disposition of the property [explain]?

One might object that it is quite difficult to catch every violator of the nondistribution constraint. This is true, but does not mitigate the argument. Easier

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69. (no author listed), "IRS is Going to 'Evaluate the Overall State of Fund Raising.'" Philanthropy Monthly 10, January 1990. In addition to reporting on this program, the article reproduces the questionnaire in full.

alternatives (such as prohibitions of high fundraising shares) might lead to more successful prosecutions and higher levels of compliance with legal mandates, but do not accomplish the underlying goals; indeed, I have argued, they are often counterproductive. No necessary law can be 100 percent enforced, and one must accept imperfect enforceability for the sort of informational problems considered here<sup>70</sup>.

Second, one might object that enforcing the nondistribution constraint, even imperfectly, is far more expensive than regulation of fundraising even if the latter is less direct. However, this objection is too narrowly framed. True, the costs to state prosecutors is lower under regulation of fundraising, but, I have argued, the costs to society (including compliance costs, less efficient generation of donations, less efficient provision of charitable service, and less efficient provision of information) are much higher. It is a mistake to regard a regulatory option as 'cheaper' merely because costs have been shifted onto someone else. Thus, I regard better protections against private inurement as the superior solution.

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70. Michael R. Darby and Edi Karni, "Free Competition and the Optimal Amount of Fraud," 16 Journal of Law and Economics 67, 1973.