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ORIGINAL PAPER

Charity Watchdogs and the Limits of Information-Based Regulation

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Abstract Transparency concerns and the concomitant accountability challenges have motivated policy and legal scholars to explore information-based regulatory approaches. We examine their usefulness in the context of the nonprofit sector which tends to show signs of governance failure. Although nonprofits are required by law to disclose information on fund use, nonprofit donors face difficulties in accessing and interpreting information about how nonprofits are deploying resources. Charity watchdogs make this information available to donors in a convenient format. In theory, this should allow donors to reward nonprofits that devote resources to service delivery and to punish those that are less careful about controlling overheads. To test the relationship between charity ratings and donations, we examine 90 nonprofits in the state of Washington for the period 2004–2007. Drawing on ratings data provided by Charity Navigator, we find that changes in charity ratings tend *not* to affect donor support to these nonprofits. We explore this statistical finding via interviews with 10 charities located in Washington State. Supporting the statistical results, we find that charities believe that donors tend not to systematically embed ratings in their donation decisions. Instead, they believe that donors assess nonprofits' effectiveness and trustworthiness via other means such as familiarity, word-of-mouth, or the visibility of the nonprofit in their community. In sum, the policy challenge is to provide information which users desire such as organizational effectiveness as opposed to basic fund allocation in the case

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of non-profits. What matters for policy efficacy is not how much information is provided but of what type.

Résumé Les problèmes de transparence et les défis concomitants de responsabilité ont motivé les institutions et les juristes pour explorer des approches réglementaires basées sur l'information. Nous examinons leur utilité dans le contexte du secteur non lucratif, qui montre des signes d'échec de gouvernance. Bien que les organisations à but non lucratif soient tenues par la loi de dévoiler des informations sur l'utilisation des fonds, les donateurs à but non lucratif font face à des difficultés pour accéder et interpréter les informations sur l'utilisation des ressources par les organisations à but non lucratif. Les associations caritatives de surveillance rendent disponibles ces informations aux bailleurs de fonds sous un format pratique. En théorie, cette action devrait permettre aux donateurs de récompenser les organisations à but non lucratif qui consacrent des ressources pour les prestations de services, et de punir celles qui sont moins rigoureuses sur le contrôle des frais généraux. Afin de mesurer le rapport entre les notations des associations caritatives et les dons, nous examinons 90 organismes à but non lucratif dans l'État de Washington, pour la période 2004–2007. Nous appuyant sur les données des notations fournies par *Charity Navigator*, nous constatons que les changements dans les notations des associations caritatives n'influencent pas le soutien des donateurs envers ces associations. Nous examinons ces conclusions statistiques par l'interview de 10 organismes de bienfaisance situés dans l'État de Washington. Soutenant les résultats statistiques, nous constatons que les associations caritatives pensent que les donateurs n'intègrent pas systématiquement les évaluations dans leurs décisions d'effectuer des dons. Au lieu de cela, elles croient que les donateurs évaluent l'efficacité et la fiabilité des associations à but non lucratif par d'autres moyens, par exemple la familiarité, le bouche-à-bouche, ou la visibilité de celles-ci dans leurs communautés. En somme, le défi politique est de fournir les informations souhaitées par les utilisateurs, telles que l'efficacité organisationnelle, par opposition à l'allocation de base des fonds dans le cas des associations à but non lucratif. Ce qui importe pour l'efficacité politique n'est pas la quantité mais le type d'information fournie.

Zusammenfassung Bedenken hinsichtlich der Transparenz und das gleichzeitige Problem der Rechenschaftspflicht haben politische und Rechtsgelehrte dazu angehalten, auf Informationen beruhende regulatorische Ansätze zu finden. Wir untersuchen ihre Nützlichkeit im Zusammenhang mit dem Nonprofit-Sektor, der oftmals Zeichen mangelnder Steuerung aufweist. Zwar sind Nonprofit-Organisationen gesetzlich dazu verpflichtet, Informationen über die Mittelverwendung offenzulegen, doch ist es für die Spendengeber schwierig, sich Zugang zu diesen Informationen zu verschaffen und zu verstehen, wie die Nonprofit-Organisationen ihre Ressourcen einsetzen. Die Aufsichtsbehörden der Wohltätigkeitsorganisationen stellen den Spendengebern diese Informationen in einem verständlichen Format zur Verfügung. Theoretisch sollte es den Spendengebern dadurch möglich sein, die Nonprofit-Organisationen zu belohnen, die ihre Ressourcen für die Bereitstellung von Dienstleistungen verwenden und diejenigen zu bestrafen, die weniger Sorgfalt bei der Kontrolle ihrer Betriebskosten ausüben. Zur Prüfung des Verhältnisses zwischen der Bewertung von Wohltätigkeitsorganisationen und den bereitgestellten Spenden untersuchen wir 90 Nonprofit-Organisationen im U.S.-Bundesstaat Washington im Zeitraum von 2004 bis 2007. Die von der Institution Charity Navigator bereitgestellten Bewertungsdaten zeigen, dass die Änderungen in den Bewertungen der Wohltätigkeitsorganisationen oftmals *keine* Auswirkungen auf die Unterstützung seitens der Spendengeber haben. Wir erforschen das statistische Ergebnis weiter anhand von Befragungen von 10 Wohltätigkeistorganisationen im Staat Washington. Im Einklang mit den statistischen Ergebnissen finden wir heraus, dass die Wohltätigkeitsorganisationen glauben, dass die Spendengeber in der Regel die Bewertungen nicht systematisch bei ihren Spendenentscheidungen berücksichtigen. Sie glauben stattdessen, dass die Spendengeber die Effektivität und Vertrauenswürdigkeit der Nonprofit-Organisationen anderweitig messen, zum Beispiel am Bekanntheitsgrad, der Mundpropaganda oder der Präsenz in ihrer Gemeinde. Zusammenfassend lässt sich sagen, dass Richtlinien zur Bereitstellung von Informationen etabliert werden sollten, die sich die Betroffenen wünschen, wie beispielsweise im Falle der Nonprofit-Organisationen Informationen zur Effektivität der Organisation anstelle von Angaben über die grundsätzliche Mittelverteilung. Ausschlaggebend für effektive Richtlinien ist nicht die Menge der bereitgestellten Informationen, sondern die Art der Informationen.

Resumen El interés por la transparencia y los retos de contabilidad consiguientes han llevado a los expertos jurídicos y políticos a analizar las estrategias normativas basadas en la información. Hemos analizado su utilidad en el entorno del sector sin ánimo de lucro, que tiende a mostrar signos de errores de gestión. Aunque las organizaciones sin animo de lucro están obligadas por ley a revelar la información sobre el uso de sus fondos, los donantes tienen problemas para acceder e interpretar la información sobre cómo estas organizaciones utilizan sus recursos. Las entidades protectoras de la caridad se encargan de que esta información esté disponible para los donantes en un formato práctico. En teoría, esto debería permitir a los donantes premiar a las organizaciones que dedican recursos a proporcionar estos servicios y castigar a aquellas que se esfuerzan poco por controlar sus gastos. Para poner a prueba la relación entre las evaluaciones y las donaciones de caridad, hemos analizado a 90 organizaciones sin ánimo de lucro del estado de Washington durante el periodo 2004–2007. Basándonos en los datos de evaluación proporcionados por Charity Navigator, hemos descubierto que los cambios en las evaluaciones de caridad no suelen repercutir en el apoyo de los donantes a esas organizaciones. Hemos analizado los resultados estadísticos a través de entrevistas con 10 organizaciones benéficas del estado de Washington. Como apoyo a los resultados estadísticos, hemos descubierto que las organizaciones benéficas creen que los donantes muestran una tendencia sistemática a no tener en cuenta las evaluaciones a la hora de decir sobre sus donaciones. En su lugar, creen que los donantes evalúan la efectividad y la formalidad de las organizaciones por otros medios, como la familiaridad, las recomendaciones o la visibilidad en su comunidad. En resumen, el reto político consiste en ofrecer la información que los usuarios desean, como la eficacia organizativa y no la asignación básica de fondos en el caso de las organizaciones sin ánimo de lucro. Lo que importa en la eficacia política no es la cantidad sino el tipo de información ofrecida.

Keywords Charity watchdogs · Accountability

Introduction

Governments fail, markets fail, and increasingly it is recognized that nonprofits can fail as well. A lack of transparency leading to misallocation of organizational resources is often an important reason for such failures. The recognition of the pervasiveness of such accountability challenges across organizational types has motivated policy and legal scholars to explore the potential of information-based regulation (Gormley and Weimer 1999; Blackman et al. 2004; Weil et al. 2006; Fung et al. 2007).[1] The premise of this regulatory approach is two fold. First, an absence of transparency creates incentives for organizations to deviate from their mandates. Second, if resource providers are provided information on the internal workings of organizations, they will act on such information. They will sanction organizations which deviate from their mandates and reward the ones which follow their mandates. Eventually, organizations which rely on the external actors for resources and legitimacy will recognize these pressures and devise new ways to deploy resources in accordance with their organizational mandates.

We investigate information-based policies in the context of the nonprofit sector. In recent years, an array of new regulatory instruments have emerged which are sponsored by private actors. These include voluntary programs and certification systems (Gunningham and Grabosky 1998; Meidinger 2001; Coglianese and Nash 2001; Potoski and Prakash 2005a, b), and increasingly, organizational report cards and information disclosure initiatives.

While donors expect nonprofits to deploy resources to support the organizational mission, they often lack the means to monitor nonprofits' resource allocation. While this may not be a problem per se, news coverage about nonprofit scandals is likely to make donors worried whether their donated resources are being utilized properly. In response to this information problem, charity watchdogs have emerged to provide easily interpretable information to donors on how non-profits deploy funds. The assumption is that donors will act upon such information by rewarding the nonprofits which deploy resources efficiently, and punishing the ones that do not (Tinkelman and Mankaney 2007). But, what if, the new information does not addresses donors' salient concerns, or the donors have insufficient incentives to embed this new information into their decisions? In this situation, the new information will not alter donor behavior, thereby raising question about policy efficacy. It will necessitate policy and legal scholars to redesign existing information-based instruments and perhaps think of new mechanisms of regulation as well.

[1] Stephan (2002) points out that the information-based approach is inspired by literatures pertaining to public management (Schneider and Ingram 1990), agenda setting (Iyenger and Kinder 1987), Coasian bargaining (Coase 1960), and comparative injustice (Hamilton 1995).

We examine the logic of information-based regulation via the theoretical lens of agency theory (Berle and Means 1932; Mitnick 1982; Waterman and Meier 1998), because the relationship between nonprofits and their donors can be viewed in agency terms (Fama and Jensen 1983; Olson 2000; Prakash and Gugerty 2010). While nonprofits can fail for a variety of reasons, agency slippages contribute to governance problems.[2] Such slippages can be traced to information asymmetries between donors and nonprofits which allow agents either to deploy organizational resources inefficiently or, worse still, to deploy these resources to pursue their own objectives. Transparency enhancing mechanisms along with a credible threat of sanctions can curb agency slippages. If these informational *and* sanctioning issues are resolved, agents will have greater incentives to pursue their mandate.[3]

Charity watchdogs embody the information-based regulatory approach. Donors want to support charitable endeavors but do not have the expertise to do so. Nonprofits have the expertise to undertake such projects but lack resources to do so. Donors, the principals, donate to nonprofits, the agents, with the expectation that nonprofits will deploy funds to pursue their mandates. Given the spate of nonprofit scandals which have received considerable media attention, however, it is clear that some nonprofits spend excessive amounts on overheads such as executive compensation and bloated bureaucracies (Gibelman and Gelman 2004).[4] There is also a sense that while most nonprofits may not intentionally misuse funds, without external monitoring, some may lack incentives to use resources efficiently.

How might donors respond in light of the media coverage on nonprofit scandals?[5] Unable to differentiate between "good" and "bad" nonprofits, some donors might view this as a "lemon problem" (Akelrof 1970) and scale back their giving across nonprofits (but see, The Charities Review Council of Minnesota 2007; O'Neill 2009).[6] Others may not want to "exit" but exercise "voice" (Hirschman 1970) by

[2] Some scholars view beneficiaries of nonprofit services as principals. Others suggest that governments be viewed as principals because along with the legal mandate and tax exemption, governments can employ nonprofits as subcontractors. We focus on donors as principals because charity watchdogs seek to mitigate information problems at the donors' end, thereby enabling donors to vote with their charity dollars.

[3] We recognize that some scholars employ the stewardship theory to study nonprofits (VanSlyke 2007). Information-based policies seek to correct information assymteries, which the agency approach identifies as they key reason for agency problems and governance failures. Non-profit donor relationship can be viewed in agency terms, and some nonprofit failures can be traced to information problems. Thus, the logic of information-based regulation coheres with the agency approach.

[4] On the issue of public confidence in the charitable or the nonprofit sector, see O'Neil (2009). Also see the surveys conducted by Paul Light and the Brookings Institute (2008).

[5] A survey conducted by *The Charities Review Council of Minnesota (*2007*)* suggests that a lack of generalized trust in charities discourages giving only in about 15% of the surveyed donors. This finding is not necessarily inconsistent with our argument. Charity watchdogs may have high traction in diverting donations from a given population of donors instead of increasing or decreasing overall levels of donations.

[6] Another body of research examines the "crisis of confidence" hypothesis in the context of volunteering for non-profits (Bekkers and Bowman 2009). Our argument is there is a perception, correct or incorrect, that nonprofits have transparency issues. Consequently, to address such perceived transparency problems, there has been an emergence of charity watchdogs. We are interested in examining whether information provided by such watchdogs has intended effects on donors; if not, then why not.

selectively supporting the "good" nonprofits. To do so, they require information regarding nonprofits' internal operations. Here in lies the problem: access to such information is difficult. While charities may be reporting such information to the government, it is difficult for an ordinary donor to access it, sort through it, and interpret it. Charity watchdogs, therefore, have the potential to mitigate this (perceived) failure in the donations market by interpreting the financial information nonprofits are required to report to the government in ways which are relevant to donation decisions. Donors can then assess nonprofits based on information available in an easy-to-use format and can direct their donations to the "good and trustworthy" nonprofits. If this hypothesis holds, nonprofits with declining ratings should experience a decline in donations while the ones with increasing ratings should experience an increase in donations. If not, nonprofit ratings will be not associated with donation levels.

Contrary to the expectation of the information-based regulatory model as operationalized by Charity Navigator, our statistical analyses of 90 nonprofits in the state of Washington for the period 2004–2007 suggest that charity ratings tend *not* to affect donor support. To get a more ground level understanding of this interesting and important finding, we conducted exploratory interviews with 10 nonprofits in Washington State. Our objective was to understand how nonprofits view charity ratings and to hear their assessment of how ratings impact their donor base. The nonprofits we interviewed provide additional support for our statistical finding: they believe that donors tend not to systematically embed watchdog ratings in their donation decisions.

What are the implications of our findings for the study of nonprofit governance, and more broadly, information-based regulations? The efficacy of information-based policies is contingent on two necessary conditions: the ability of users to access *relevant* information at low transaction costs and the willingness of users to change their behavior based on this new information. We find that Charity Navigator does not provide the appropriate information about nonprofits to donors and donors do not systematically embed this new information in their donation decisions. This calls for redesigning charity watchdogs so that they disclose information which donors actually want, and rethinking the behavioral assumptions about the typical donor on which this approach is predicated. Specifically, in the nonprofit sector, information-based approaches might be more useful when disclosures provide information regarding organizational effectiveness as opposed to basic fund allocation. Our article should not be viewed as a repudiation of information-based approaches. Rather, we suggest that the efficacy of this approach is not necessarily influenced by provision of more information per se but on the disclosure of information which relate to the salient concerns of the targeted users.

Charity Ratings as Information-Based Regulation

Regulation can be viewed as a rule, norm, or law designed to influence the behavior or conduct of a given set of actors. It can permit, prescribe, or prohibit specific behaviors which are judged against certain principles or standards. To be effective, regulations need to be enforced and backed by sanctions. Typically, regulations are supplied and enforced by the state in its jurisdiction. Indeed, the OECD defines regulation as "as imposition of rules by government, backed by the use of penalties that are intended specifically to modify the economic behavior of individuals and firms in the private sector."[7]

In recent years, scholars have tended to take a more expansive view of regulation. First, scholars recognize that regulations might be supplied by non-governmental actors. There is a well-established literature on voluntary codes, private authority regimes, and social regulation which studies how such regulatory systems emerges, how they get diffused, and under what conditions they are effective (Gunningham and Grabosky 1998; Prakash and Potoski 2006). Second, scholars recognize that coercion alone may not suffice to induce compliance. This is certainly true for regulation supplied by non-state actors who cannot legitimately marshal the coercive power of the state. This also holds for some cases of state-supplied regulation where monitoring and enforcement is expensive (Coglianese and Nash 2001). Thus, scholars have looked for alternative mechanisms to induce compliance, including mobilizing the power of outside stakeholders, media and the market which can then benchmark the poor performers (Fung and O'Rourke 2000). Information-based regulation falls in this category whereby outside actors create material and non-material incentives for regulatees to comply with some set of obligations.

Given the transparency revolution in last two decades, a number of information-based regulatory systems have emerged in areas as diverse as toxic emissions (Konar and Cohen 1997), healthcare (Cutler et al. 2004), food and water safety (Bennear and Olmstead 2008), surgical outcomes (Peterson et al. 1998), education (Stake 2006), and nonprofits (Silvergleid 2003). The Environmental Protection Agency is now actively considering establishing greenhouse gas emission registry analogous to the toxics release program.[8]

Charity watchdogs have emerged in response to scandals highlighting the fact that some nonprofit managers have abused organizational resources for personal benefits (Greenlee et al. 2007; Gibelman and Gelman 2004). As a result, instead of simply assuming that nonprofits as a category are trustworthy based on the non-distributional constraint (Hansmann 1980 but see Ortmann and Schlesinger 2003), stakeholders, policy makers, and academics are advocating new ways to enhance accountability and transparency of nonprofits (Keating and Frumkin 2003). In response, governments, charity watchdogs, and nonprofit associations have sponsored initiatives which include new governmental regulations, self-regulatory codes or third-party sponsored voluntary codes,[9] and charity rating

[7] http://stats.oecd.org/glossary/detail.asp?ID=3295; accessed 03/20/09.

[8] http://www.epa.gov/climatechange/emissions/ghgrulemaking.html; 04/18/2009.

[9] There is an increased interest in studying the use of voluntary programs and accreditation system by nonprofits to signal their trustworthiness to donors. Bekkers (2003) examines the case of the Netherlands where NGOs use the accreditation system to signal their trustworthiness. Gugerty and Prakash's (2010) edited volume provides numerous case studies of how nonprofits have used voluntary programs to signal their trustworthiness to different stakeholders. In the context of the broader debate on the accountability of NGOs, see the special issue of *Chicago Journal of International Law*, 2002, 3(1).

systems.[10] These mechanisms seek to foster accountability by, inter alia, imposing new disclosure requirements. The hope is that these mechanisms will increase public scrutiny of nonprofits and enable donors to differentiate the bad ones from the good ones. Arguably, along with solving the "internal adulteration" problem, these ratings could create higher entry barriers for "bad" nonprofits and solve the "external adulteration" problem (Ortmann and Schlesinger 2003).

There is an extensive literature on the effects, implications, and forms of nonprofit accountability mechanisms (Ebrahim 2005; Edwards and Hulme 1996; Sidel 2008). Accountability standards can be controversial if they impose additional burden on nonprofits (Ebrahim 2005; Melendez 2001). In such cases, overheads might increase to satisfy donors who want to see paper trails, reporting systems, or employ auditors. Ratings systems which collect information from tax reports are therefore promising because they are based on information which nonprofits are already required to report. Further, charity watchdogs do not require monitors and enforcers other than the stakeholders who are assumed to have the motivation to acquire and process the disclosed information. Given the limited resources of nonprofits, the rating model has the potential to be an effective method of regulating nonprofits without imposing new costs on the regulatees, either in the form of time or money.[11]

However, rating systems such as charity watchdogs have limitations. First, while it is relatively easy to apply quantifiable metrics to financial figures, it is more difficult to do the same for programmatic content and quality, which arguably should be the more important criteria for assessing nonprofits. Consequently, current charity ratings tend to provide a somewhat simplistic understanding of complex organizations which often undertake multiple roles, a problem typical of commensuration (Espeland and Stevens 1998).[12]

Second, organizations may "play to the test," or alter behavior or organizational structure in ways that increase ratings without impacting (or while negatively impacting) the qualities the ratings are designed to evaluate (Espeland and Sauder 2007; Tinkelman 2009). Because charity ratings are based on financial information

[10] Sidel (2008) examines new nonprofit governance initiatives in developing countries. In the context of India, he notes the emergence of "a nonprofit rating scheme initiated by Indianngos.com, ratings of microcredit finance institutions in India and around Asia undertaken by Micro-Credit Ratings International Ltd. (M-CRIL), and the emergence of powerful domestic funding intermediaries that imposed or negotiated self-regulatory principles and rules on their downstream Indian funding recipients and partners."

[11] Sidel (2008) identifies intranet regulation as a new model of NGO regulation.

[12] Gromley and Weimer (1999) suggest that opinion leaders play an important role in familiarizing different audiences with "organizational report cards." In addition to politicians and celebrities, opinion leaders include professionals such as high school counselors, who reduce consumers' search costs by directing their attention to most salient or important reports that these consumers should consider in making their choices. In this context, see Lee (2004) who evaluates "e-reporting" by various federal and state agencies.

rather than programmatic content or success, nonprofits are given the incentive to focus on changing financial practices at the expense of the organizational mission or quality of programming (Ebrahim 2005).

Third, ratings may turn out to be self-fulfilling prophecies. For example, in the case of *U.S. News and World Reports* law school rankings, schools that received low ratings subsequently received weaker applications and faced increased difficulty in fundraising. These effects helped to cement schools' positions in the rankings, thereby giving schools incentives to "game" the rankings rather than improve program quality (Stake 2006).

It is fair to say that notwithstanding the above limitations, ratings systems and organizational report cards (Gormley and Weimer 1999) have become an integral part of modern life. Charity watchdogs perform a function similar to that of agencies that seek to solve information problems in the financial markets which rate individual creditors (e.g., Equifax) as well as corporations (e.g., Moody's) with the objective of providing a summary assessment (via a credit score or a bond rating) of an individual or organization. This assessment helps lenders evaluate the creditworthiness of the borrower. Likewise, charity watchdogs rate nonprofits on explicit financial and organizational criteria and provide this information to consumers either free or for a fee. Donors can then compare across nonprofits or examine a given nonprofit over time on a variety of organizational and financial parameters.[13]

Several watchdog organizations evaluate and make public information about the organizational and financial dimensions of nonprofits. These include Charity Navigator, Charity Register, Wise Giving Alliance, Ministry Watch, and the American Institute of Philanthropy.[14] An emerging literature evaluates the effectiveness of charity ratings in shaping donor behavior. Employing the ratings provided by the Better Business Bureau's (BBB) Wise Giving Alliance[15] on charities in New York City, Sloan (2008) reports that "pass" ratings increase donations. However, neither "do not pass" ratings nor a lack of ratings affect donations. Chhaochharia and Ghosh (2008) examine ratings provided by the

[13] Unlike some other cases of information-based regulation, charity ratings do not reflect program outcomes. Yet, even information-based systems reporting program outcomes have problems, as discussed above. The broader message we want to convey is that no evaluation system is perfect; once the method of rating or evaluation is known, organizations "play to the test" and it leads to its own perversities. Because no information-based system can perfectly measure outcomes in their full complexity and at the same time create incentives for the evaluated actors to game the system, almost all such systems will have problems.

[14] The Charities Review Council of Minnesota's (2007) online Accountability Wizard differs from charity watchdog because nonprofits elect to provide information pertaining to their compliance with the Council's standards that pertaining to Public Disclosure, Governance, Financial Activity and Fundraising.

[15] The BBB Wise Giving Alliance gives charities a "pass," "no pass," or "undetermined" rating based on governance and oversight, effectiveness, finances, and fund-raising and informational materials (Sloan 2008).

American Institute of Philanthropy (AIP).[16] They find that charities that have the lowest rating have 16% less contributions than charities with the highest rating. However, Silvergleid (2003), who also uses data from AIP, does not find a link between ratings and contributions.

It should be noted that in each of these studies, the charity watchdog analyzed did not assess all nonprofits. The BBB gives priority to the organizations that are "larger and/or receive the most consumer requests for ratings" (Sloan 2008: 6), and the AIP ratings, used by Chhaochharia and Ghosh as well as Silvergleid, provide data annually for a sample of 500 charities.

The above studies have made important contributions to our understanding of the effectiveness of charity watchdogs. We build on their contributions and further this literature in several ways. First, we make an obvious but overlooked methodological contribution. Most studies tend to used a 1-year lag between ratings and donations, when, in fact, a 2-year lag would be necessary to accurately measure the effect of ratings on donations. This is because ratings made available by the watchdogs in 2003 are often based on 2001 data. Consequently, our study employs a 2-year lag between changes in ratings and changes in contributions.

Second, in relation to ratings provided by some other charity watchdogs, Charity Navigator allows for a more granular evaluation of nonprofits.[17] For example, unlike Sloan's study, which uses the BBB's pass/do not pass ratings, our study uses Charity Navigator's 0–4 rating scale, allowing us to evaluate the impact of changes in ratings on contributions. As a result, instead of examining whether higher rated charities receive higher donations, we are able to test whether increases or decreases in charity ratings have an impact on contributions. Further, unlike Chhaochharia and Ghosh (2008) who only looked at the difference in donations between the highest- and lowest-rated charities, we seek to test the impact of the changes in ratings on changes in donations for the entire range of ratings for all charities operating in a given jurisdiction (the state of Washington) that fulfill the Charity Navigator requirements for being rated.[18]

Third, we examine the influence of increases in ratings on donations *separately* from the influence of decreases in ratings. Although Silvergleid (2003) tests whether changes in ratings impact changes in donations, he tests increases and decreases

[16] The American Institute of Philanthropy gives charities a letter grade (A, B, C, D, F) based on the percentage of money spent on programs, the cost to raise funds, and the years of available assets (Silvergleid 2003).

[17] Our use of Charity Navigator's ratings in this analysis should not be considered an endorsement of its rating system. We chose to use Charity Navigator in this study not because we agree with its methodology but rather because it is one of the most widely cited charity ratings organizations in the media and because it rates the largest number of charities. Our goal is not to advocate for Charity Navigator but rather to assess the claims regarding its impact on donors.

[18] Charity Navigator rates all 501 (c)(3) organizations that fulfill the following criteria: file a Form 990, have public support greater than $500,000 in the most recent fiscal year, have completed a Form 990 for four consecutive years, are based in the US, and are registered with the IRS. Charity Navigator excludes hospitals, hospital foundations, universities, colleges, community foundations, PBS stations, land trusts and preserves, charities that receive most of their funding from government grants or from fees they charge for their programs and services, and charities that report $0 in fundraising expenses. *Source*: www.charitynavigator.org. For a breakdown of all 501 (c)(3) organizations in Washington State by category, including those not rated by Charity Navigator, see http://www.tess.org/NPinWA/07NTEEbyCounties.html.

together. This is problematic because a positive coefficient of the key variable (changes in ratings) is consistent with cases when increases in donations respond to increases in ratings as well as decreases in donations respond to decreases in ratings.[19] In reality, donors might exhibit asymmetrical responses to increases and decreases in ratings. That is, donors might "reward" charities for improved ratings but not "punish" them for declining ratings, or vice versa. Our study is thus able to separately examine the donors' "reward" decision from the "punish" decision.

Our quantitative analysis focuses on charities rated by Charity Navigator in the state of Washington for the period 2004–2007. Charity laws are often state specific and this could affect the rating dynamics. Thus, focusing on a given state enables us to hold the broader institutional environment constant for the 90 charities we examined. To supplement our quantitative analysis, we conducted interviews with 10 nonprofits in Washington State. By interviewing the Washington-based nonprofits, we sought to understand how nonprofits view donors' response to watchdog ratings. Our interviews confirm the results of our quantitative analysis: ratings do not affect revenue because the assumptions about donor behavior on which information-based regulations are based tend not to hold in this issue area.

Although our quantitative analysis focuses on donors, for our interviews, we decided to talk to charities. Given the large numbers that can potentially donate, donor interviews were not a viable option. Nonprofits are far fewer in number and therefore the information they provide might be less idiosyncratic. Further, as actors competing to attract donations from citizens, nonprofits can be expected to have a good sense of how their donor base determines its charitable giving. Finally, given that nonprofits work in different issue areas and arguably might appeal to different sets of donors, by interviewing a variety of types of nonprofits, we were able to get information about a range of donors.

Data and Methods

We examine whether changes in charity ratings influence primary revenue as well as donor contributions to nonprofits located in Washington State by examining the rating data provided by Charity Navigator for the period 2004–2007. Charity Navigator constructs its ratings by analyzing information that U.S. nonprofits are required to disclose to the federal government on Form 990, a key instrument of nonprofits' financial accountability in the United States (Keating and Frumkin 2003).[20] Although Form 990 is available for public

[19] Konisky (2007) makes a similar point in his article on regulatory races to the bottom.

[20] In addition to the transparency dimension is the notion that donations are tax-deductible. This gives these organizations more "publicness" in terms of revenue conception, role, and protection. Indeed, 501 c3s are required to make their Form 990s publicly available, and websites such as Guidestar increase the ease with which citizens can access these documents. Donors to 501c 3s may have a greater distance from the operations of the nonprofits (creating the information asymmetry problem we identify) than they might to the exempt religious 501c 3s (which tend to have greater participation by their donors in their operations and services) or political nonprofits (donations to which are generally not tax exempt). These distinctions are not only important to the agency theory explication, but also reinforce our point regarding the importance of proximity to donor-decision making.

viewing, it is difficult to understand. Also, the costs for citizen donors to compare across charities based on this form are prohibitive (Bekkers 2003). Charity Navigator makes the information provided in the Form 900 easier to interpret and compare. It rates various nonprofits on scale of zero (very poor) to four (excellent) stars based on two broad categories: organizational efficiency and organizational capacity. Organizational efficiency measures the ratio of spending that goes towards programming versus administrative and fundraising costs. Organizational capacity attempts to measure the prospects for growth and survival of nonprofits by considering total revenue growth, program expenses growth, and reserves of liquid assets. These ratings are made available irrespective of whether the rated nonprofits wish them to be publicized. In this sense, information-based regulation should not be confused with voluntary regulation in which regulatees elect to join the regulatory scheme.

Our dataset includes all charities listed on Charity Navigator in Washington State from 2004 to 2007. Twenty-five organizations currently listed on Charity Navigator were not rated in 2004, and three other organizations had missing data for the contributions model and two for the primary revenue model. Therefore, our models ultimately included 89 and 90 cases, respectively.

Four reasons motivate us to use the ratings provided by Charity Navigator. First, it provides the most comprehensive set of ratings for a range of nonprofits. While the American Institute of Philanthropy rates 500 charities a year and the BBB Wise Giving Alliance currently rates 1,790 charities, Charity Navigator rates over 5,000 charities each year.[21] Second, because it is perhaps the best known among the charity watchdogs, donors are most likely to monitor its ratings and respond to them. As per Charity Navigator's website, in 2008 more than four million donors used the site. In 2007, Business Week inducted Charity Navigator into its "Philanthropy Hall of Fame" for "revolutionizing the process of giving." Charity Navigator was singled out in 2006, 2007 and 2008 by Kiplinger's Financial Magazine as "One of the Best Services to Make Life Easier" and Esquire Magazine recently told its readers that using their service was one of "41 Ways to Save the World." Third, while organizations such as the AIP require a "donation" of $40 or more in order to access the ratings, Charity Navigator ratings are freely available and thus more accessible to the general public. Finally, Charity Navigator claims that its ratings have had a significant impact on donor behavior. A recent email from Ken Berger, President and CEO of Charity Navigator (2009) (also posted on their website) claims that "in a survey of our donors last spring, 83% of the 600 who responded said that Charity Navigator significantly affects their giving decisions. A study by the University of Wisconsin put the figure at an even higher 92%." Given the key place of Charity Navigator among charity watchdogs, we believe it is important to examine how actual behavior might cohere or differ from their claimed

[21] We could not find the data for the number of charities rated by BBB and AIP in the state of Washington. We assume that similar to the national coverage, in relation to BBB and AIP datasets, the Charity Navigator dataset offers a more comprehensive coverage of charities in this as well.

behavior, and how claims about the efficacy of charity ratings hold when subjected to empirical scrutiny.

According to the Charity Navigator website, its ratings "show givers how efficiently a charity will use their support today, and to what extent the charities are growing their programs and services over time."[22] Charity Navigator thus rates organizations "by evaluating two broad areas of financial health, their organizational efficiency and their organizational capacity" (Appendix 1).[23] The final calculations result in a 0–4 star rating system, with 0 indicating "Exceptionally Poor: Performs far below industry standards and below nearly all charities in its Cause" and four indicating "Exceptional: Exceeds industry standards and outperforms most charities in its Cause."

Charity Navigator does not directly evaluate program effectiveness or outcomes in its ratings. Its ratings are, however, based in part on the percentage of total funding devoted to fulfilling the organizational mandate via programs. By extension, program content and quality are measured, though only through percentage of overhead put towards programming rather than administration. This metric inherently, though probably unintentionally, ties quality of programming to the amount of money spent on it. In reality, organizations with excellent program content and outcomes may have higher rates of administrative overhead, an issue that was raised during our interviews. Consequently, Charity Navigator ratings may influence donors to favor organizations with lower administrative overhead but poorer program outcomes.

Model

Our key independent variable is changes in *overall ratings* from 2004 to 2005. Our key response variable is percentage changes in *primary revenue* from 2006 to 2007. *Primary revenue* includes contributions, program services, and membership fees. Arguably, ratings might influence not only the donations but also other types in revenue sources. In particular, membership fees are often voluntary contributions that may be more reflective of individual donors' attitudes towards the organization than overall donations. However, ratings changes may most directly impact changes in donations. We therefore also test whether changes in *overall ratings* from 2004 to 2005 are associated with percentage change in *contributions* (or donations) from 2006 to 2007.

We also test whether changes in the ratings of the two subcategories, *organizational efficiency* and *organizational capacity*, individually have an effect on *contributions* and *primary revenue*. Finally, we test separately for the effect of increases and decreases in ratings because donors may not respond symmetrically to both signals.

[22] http://www.charitynavigator.org/index.cfm?bay=content.view&cpid=484#11, downloaded on 03 March 2009.

[23] A survey sponsored by Better Business Bureau Wise Giving alliance suggests that 79% of Americans believe that "it is important to know the percentage of spending that does towards charitable programs." (cited in Bekkers 2003, p. 600).

Our models control for several factors which can plausibly influence *revenue* and donor *contributions*. We control for changes in the amount spent on *fundraising* from 2005 to 2006 because higher levels of marketing expenditures can lead to higher contributions in subsequent years. In addition, donor support might be influenced by the *longevity* of the organizations: organizations which have a track record and have been functioning for a long period of time might have a superior reputation (Okten and Weisbrod 2000) and therefore come across as being more trustworthy. Consequently, we control for the number of years an organization has been in existence. It is also possible that different types of organizations have different contribution patterns. Therefore, we include dummy variables for organizational *mission*: humanitarian, religious, animal, public benefit, health, art, education, and environment. Charity Navigator also classifies some organizations as having an "international" mission. Because "international" alone is not a mission, we placed these organizations in the most appropriate category based on the information they provide about their missions on their websites. Finally, contributions may vary based on whether the organization operates primarily locally or whether it operates on a nation-wide or international scale. The activities of local charities can be observed by donors while for charities with nation-wide or overseas operations, donors have to rely on other sources of information. Therefore, we included a dummy variable (*scope*) coded as "0" if the organization's outreach is primarily local and "1" if the outreach is national or international. Finally, our model controls for the size of the organization because large organizations tend to have a higher name recognition which may lead to higher levels of contributions. We therefore include *net assets* (logged) in the regression as a proxy for the size and visibility of the organization.[24] Our models are as follows:

Model 1: ΔPrimary Revenue = f(Increase in overall rating, ΔFundraising expenses, Longevity, Mission, Scope, Net assets,);

Model 2: ΔPrimary Revenue = f(Decrease in overall rating, ΔFundraising expenses, Longevity, Mission, Scope, Net assets,);

Model 3: ΔPrimary Revenue = f(Increase in efficiency rating, ΔFundraising expenses, Net assets, Longevity, Mission, Scope);

Model 4: ΔPrimary Revenue = f(Decrease in efficiency rating, ΔFundraising expenses, Longevity, Mission, Scope, Net assets,);

Model 5: ΔPrimary Revenue = f(Increase in capacity rating, ΔFundraising expenses, Longevity, Mission, Scope, Net assets,);

Model 6: ΔPrimary Revenue = f(Decrease in capacity rating, ΔFundraising expenses, Longevity, Mission, Scope, Net assets,)

We then repeat the regressions with Δ*Contributions* as the dependent variable (Models 7–12). We provide descriptive statistics for our variables in Appendix 2.

Illustrative Interviews

To supplement the quantitative analysis, we conducted targeted interviews to get a sense about how nonprofits respond to charity ratings. Via our interviews, we sought

[24] We tested for colinearity between the variables before running the models and did not find any.

to understand whether or not charities are aware of the ratings and if they believe that donors alter their giving based on ratings, whether positive or negative.

Although most studies of determinants of nonprofit donations have failed to include reputation as a factor, the few that have evaluated the impact of reputation on donations have found peer reputation to be a strong determinant of funding (Tassie et al. 1996; Padanyi and Gainer 2003). We therefore use our interviews as an opportunity to evaluate the impact of ratings on reputation and reputation on contributions.

Following the advice laid out by King et al. (1994), we interviewed nonprofits which vary on a host of independent variables. We conducted two rounds of interviews. In the first, we selected nonprofits with different ratings patterns, i.e., an organization with consistently high ratings, an organization with consistently low ratings, an organization that experienced a decline in ratings, and an organization that experienced an improvement in ratings. In this way, we were able to get a preliminary sense about whether organizations with different ratings patterns shared similar or different perspectives on the value and efficacy of ratings. In addition, we interviewed different types of nonprofits: human services, environment, international, and public benefit to explore not only whether nonprofits believe that ratings are important to their donors but also if donors of some types of nonprofits are perceived to be more receptive to ratings than others.[25] Different types of organizations require different administrative structures which could, in turn, influence overhead costs. Consequently, donors may understand that some organizations require higher overheads than others and incorporate this calculation into their response to ratings. Following the advice of our reviewers, we conducted a second round of interviews in order to increase the representativeness of our sample. In this round, we interviewed a random sample of organizations in the dataset. Conveniently, they also varied by ratings pattern, size, and mission. In this round, we initially contacted approximately 20 organizations by email. Six responded, and we interviewed all of them (see Appendix 3 for case section).

Results

Quantitative Analysis

Employing Ordinary Least Squares (OLS) regression models, we report 12 models in total. Descriptive statistics are reported in Appendix 4. Models 1–6 in Table 1 present our results of how changes in *ratings* influence percentage changes in *primary revenue*. Models 1 and 2 present how *primary revenue* responds to increases and decreases in *overall ratings*. Models 3 and 4 present how *primary*

[25] For our exploratory case studies, we sought to focus on areas in which donors have a choice to move their funds to another charity working in broadly the same area. Donors in Washington State have sufficient choice regarding charities from which to choose in each mission area. For example, of the Washington State nonprofits listed on Charity Navigator, 14 organizations are dedicated to the environment, 11 to education, and 16 to the arts.

Table 1 OLS regressions measuring the impact of increases and decreases (separately) of overall ratings, efficiency ratings, and capacity ratings on changes in primary revenue

Impact on primary revenue	Overall ratings		Efficiency ratings		Capacity ratings	
	Increase Model 1	Decrease Model 2	Increase Model 3	Decrease Model 4	Increase Model 5	Decrease Model 6
Intercept	−58.0*** (16.76)	−60.3*** (16.94)	−58.9*** (16.63)	−60.1*** (17.00)	−56.2** (16.61)	−61.9*** (17.23)
Ratings change	−5.21 (7.64)	−1.68 (8.46)	−6.75 (7.22)	−3.04 (7.22)	−10.28 (7.52)	−5.19 (7.50)
Fundraising change	2.85 (6.85)	1.88 (6.84)	2.25 (6.77)	2.80 (6.96)	1.35 (6.74)	2.67 (6.75)
Net assets	2.84*** (0.77)	2.84*** (0.77)	2.88*** (0.77)	2.87*** (0.79)	2.79*** (0.76)	2.95*** (0.80)
Longevity	0.07 (0.09)	0.12 (0.09)	0.07 (0.08)	0.09 (0.09)	0.03 (0.09)	0.10 (0.08)
Type: Humanitarian	18.78* (10.79)	18.57* (10.84)	19.44* (10.77)	18.42* (10.86)	20.04* (10.69)	18.54* (10.79)
Scope	26.58** (7.89)	26.61*** (7.86)	26.84*** (7.87)	26.05** (7.90)	27.01*** (7.80)	26.51** (7.92)
Type: Religious	8.45 (12.61)	9.06 (12.56)	10.26 (12.57)	8.85 (12.63)	8.98 (12.42)	9.40 (12.57)
Type: Animal	11.52 (13.15)	13.28 (13.30)	14.22 (13.32)	11.89 (12.07)	11.69 (13.00)	10.79 (13.16)
Type: Public benefit	18.47 (11.15)	17.95 (11.09)	18.94* (11.09)	17.65 (11.18)	19.09* (11.00)	18.44 (11.11)
Type: Health	10.72 (12.12)	11.57 (12.04)	12.24 (12.01)	11.64 (12.07)	9.57 (11.99)	11.72 (12.06)
Type: Art	11.61 (12.34)	12.55 (12.32)	11.85 (12.28)	10.92 (12.44)	12.10 (12.20)	11.55 (12.38)
Type: Education	17.57 (13.73)	17.88 (13.70)	17.46 (13.66)	17.59 (13.74)	16.64 (13.56)	17.92 (13.75)
Type: Environmental	15.94 (12.54)	15.21 (12.49)	16.43 (12.51)	14.81 (12.53)	15.29 (12.34)	14.04 (12.59)
Rating change * Duration	0.05 (0.13)	0.10 (0.13)	0.60 (0.12)	0.04 (0.11)	0.21 (0.14)	0.09 (0.15)
R-squared	0.27	0.28	0.28	0.27	0.29	0.27
F-statistic	2.01	2.06	2.06	1.98	2.19	2.01
$N = 90$						

Net assets is highly statistically significant in all these models, but due the extremely small values, not substantively significant

* $p < .10$, ** $p < .05$

revenue responds to increases and decreases in *efficiency ratings*. Models 5 and 6 present how *primary revenue* respond to increases and decreases in *capacity ratings*.

Models 7–12 in Table 2 present the results of how changes in *ratings* influence changes in *contributions*. Models 7 and 8 present how *contributions* respond to increases and decreases in overall *ratings*. Models 9 and 10 present how *contributions* respond to increases and decreases in *efficiency ratings*. Models 11 and 12 present how *contributions* respond to increases and decreases in *capacity ratings*.

The key finding is that across models, changes in *ratings* are not associated with changes in either *primary revenue* (Table 1) or *contributions* (Table 2).[26] *Net assets* and *scope* are statistically significant predictors of changes in *primary revenue* across regressions (Table 1) but not for changes in *contributions* (Table 2). Organizational size (*net assets*) may be associated with increases in primary revenue in subsequent years because large organizations have higher name recognition or because their capacity to solicit donors is greater. Likewise, having a national or international scope predicts increases in *primary revenue*.

Our findings diverge from previous research in several ways. Sloan (2008) found that Wise Giving Alliance "pass" were associated with higher donations. Chhaochharia and Ghosh (2008) found that charities with the lowest American Institute of Philanthropy rating received 16% less in contributions than charities with the highest rating. We speculate that our results differ because, in the case of Wise Giving Alliance, organizations apply to be rated and then publicize the results when they receive a "pass" rating but not when they receive a negative rating. The fact that organizations elect to be rated also suggests a possible endogeneity problem between an organization's decision to select itself in and its ratings. Further, Sloan's model only incorporated a 1-year time lag: 2000 ratings regressed against 2001 donations. As we pointed out earlier, this lag is insufficient because ratings based on year 2000 tax returns are not usually available until late 2001—in which case they will not appear in the ratings until 2002.

Chhaochharia and Ghosh's (2008) results likely differ because of differences in the research design: while our study examines whether changes in ratings lead to changes in donations, Chhaochharia and Ghosh compared the differences in donations received by the highest rated to lowest rated charities. Arguably, there might be a missing variable that accounts both for high (low) ratings and high (low) contributions. Instead of high ratings being the cause of high contributions, both of these factors may be the result of an unknown variable, and Chhaochharia and Ghosh's model may therefore exhibit endogeneity problems. Our study avoids this problem by measuring *changes* in ratings and *changes* contributions. In doing so, we reduce the possibility of preexisting factors (especially time invariant ones) accounting for our results. Consequently, the question we examine is not whether highly rated charities receive higher levels of donations, but whether "consumers" of ratings change their behavior in response to new information. Based on the

[26] We also ran our models with dichotomized dependent variables, i.e., the dependent variable is coded as 1 if ratings increase and 0 if ratings did not change or decreased (and vice versa). These models also did not support the hypothesis that changes in *ratings* are associated with changes in *primary revenue* or *donations*.

Table 2 OLS regressions measuring the impact of increases and decreases (separately) of overall ratings, efficiency ratings, and capacity ratings on changes in contributions

Impact on contributions	Overall ratings		Efficiency ratings		Capacity ratings	
	Increase Model 7	Decrease Model 8	Increase Model 9	Decrease Model 10	Increase Model 11	Decrease Model 12
Intercept	0.53 (1.27)	0.74 (1.27)	0.52 (1.25)	0.88 (1.26)	0.49 (1.27)	0.75 (1.29)
Ratings change	0.30 (0.58)	0.31 (0.63)	0.71 (0.54)	0.53 (0.54)	0.27 (0.58)	0.49 (0.56)
Fundraising change	−0.28 (0.52)	−0.17 (0.51)	−0.23 (0.51)	−0.13 (0.52)	−0.29 (0.52)	−0.29 (0.51)
Net Assets	−0.02 (0.06)	−0.02 (0.06)	−0.03 (0.06)	−0.03 (0.06)	−0.02 (0.06)	−0.03 (0.06)
Longevity	0.005 (0.007)	0.001 (0.007)	0.006 (0.006)	−0.0004 (0.007)	0.005 (0.007)	0.001 (0.006)
Type: Humanitarian	0.09 (0.82)	0.11 (0.81)	0.04 (0.81)	0.23 (0.81)	0.08 (0.82)	0.14 (0.81)
Scope	−0.20 (0.60)	−0.21 (0.59)	−0.23 (0.59)	−0.20 (0.59)	−0.19 (0.60)	−0.16 (0.60)
Type: Religious	−0.16 (0.96)	−0.19 (0.94)	−0.30 (0.94)	−0.14 (0.94)	−0.19 (0.95)	−0.20 (0.95)
Type: Animal	−0.03 (1.00)	−0.25 (1.00)	−0.19 (1.00)	−0.21 (0.99)	−0.03 (1.00)	0.10 (0.99)
Type: Public benefit	−0.19 (0.84)	−0.13 (0.83)	−0.21 (0.83)	−0.14 (0.83)	−0.17 (0.84)	−0.20 (0.84)
Type: Health	−0.23 (0.92)	−0.24 (0.91)	−0.32 (0.91)	−0.28 (0.91)	−0.20 (0.94)	−0.21 (0.91)
Type: Art	0.65 (0.93)	0.55 (0.92)	0.67 (0.92)	0.72 (0.93)	0.68 (0.94)	0.61 (0.93)
Type: Education	−0.56 (1.04)	−0.57 (1.03)	−0.52 (1.03)	−0.50 (1.03)	−0.52 (1.04)	−0.50 (1.04)
Type: Environment	0.19 (0.95)	0.20 (0.94)	0.09 (0.94)	0.24 (0.94)	0.21 (0.95)	0.34 (0.95)
Rating change * Duration	−0.006 (0.01)	−0.01(0.01)	−0.01 (0.009)	−0.01 (0.008)	−0.004 (0.01)	−0.01 (0.01)
R-squared	0.06	0.09	0.08	0.09	0.06	0.08
F-Statistic	0.36	0.52	0.46	0.51	0.35	0.44
$N = 89$						

In no scenario do changes in ratings impact changes in contributions, nor are any of the other variables statistically significant

* $p < .10$, ** $p < .05$

results of our regression models, the evidence suggests that changes in ratings are associated with changes in contributions.

Evidence from Interviews

Do ratings reflect the trustworthiness of charities and therefore influence the financial support they receive from donors? We decided to further examine this complex subject by conducting 10 interviews which covered four primary categories: organizational awareness of ratings, impact of ratings on donors and donations, impact of reputation on donors and donations, and other factors that motivate donors to give. The ten organizations interviewed vary in size, mission, scope, and ratings pattern (See Appendix 3). Despite these differences, the organizations were nearly unanimous in their responses in all four categories.

All ten organizations were aware of Charity Navigator, nine of the ten knew their current rating, and seven of the ten systematically track the ratings. Given the attention paid to ratings, one would guess that they have a clear impact on donations. According to the interviewees, however, this is not the case. Although two organizations speculated that low ratings might deter some first-time donors, none believed that they were losing donors because of ratings. Five organizations specifically mentioned the fact that major donors, foundations, and corporate donors, often the source of the majority of contributions, at times do look at ratings, but have a strong relationship with the organization, do their own research, and do not let anybody form their opinions for them.

For example, the Humane Society of Tacoma and Pierce County experienced a significant drop in ratings due to a strategic decision to give the animal control contracts back to the city, which damaged the organization's capacity rating and therefore the overall rating. Marguerite Richmond, the Director of Development, reported that the change in ratings did not have any effect on major donors, who weigh what they know about the organization more than the rating. Similarly, Michael Schindler, the Development Director of Stronger Families, reported that ratings do not have much of an impact on his donors because Stronger Families does a lot of work through "personal touch." According to Schindler, word of mouth referrals and strong name recognition have a larger impact on trustworthiness and donations than do third-party ratings.

Stephenie Williams, the Director of Planning, Analysis & Reporting for World Vision, speculated that many donors are unsure of how to interpret the ratings when making their own giving decisions because Charity Navigator ratings are based primarily on financial data. From her perspective, donors are likely to seek information on program efficacy, an issue about which the ratings systems do not provide direct evidence. Arguably, ratings systems can be misleading on this count: by reducing its overhead expenditure, an organization could improve its ratings but undermine infrastructure necessary for successful program outcomes.

That being said, three organizations reported that they have gotten indications that donors are looking at the Charity Navigator ratings. In the case of Unitus, some online donors have indicated that they heard about the organization from Charity Navigator. Kate Cochran, the Vice President of External Relations, also noted that in conversation, donors sometimes ask how much money goes to overhead versus program work, an indication that they may be familiar with Charity Navigator's metrics. But although it is clear that some donors are looking at Charity Navigator ratings, it is not clear how strongly ratings are factored into donor decisions. For example, this year Unitus' rating dropped a star, but Cochran has not heard from any donors that dropping a star is affecting their giving.

If ratings are not motivating donors giving decisions, what is? According to Wendy Tyner, the Development Director of Mountains to Sound Greenway Trust (MTS), "Reputation is 1000% more important than ratings." Although she recognizes that some donors might follow Charity Navigator ratings, she believes that Charity Navigator is one of the many factors that influence donors' giving decisions. In her experience, donors also consider factors such as the overall budgets, types of projects, the perceived impact on the community, the age of the organization, the endowment, current initiatives, the last annual report, donor referrals, and board membership. Many donors are also volunteers and are therefore familiar with MTS at a level that Charity Navigator's simplified ratings cannot communicate.

Tyner is not alone. Across the board, the degree of importance attributed to reputation was cited as "high" or "huge." Anna Fahey, the Communications Strategist of Sightline, commented "Reputation is everything in some ways." Williams of World Vision commented that ratings are not donors' primary concern: "World Vision donors give because they believe in the World Vision mission, which overrides what any website says about the organization." Similarly, Jon Eastlake, the CFO of the Delta Society, said that donors give because they are familiar with the work the organization is doing and because they believe in the strength of the human animal bond and the health benefits of it.

Cochran of Unitus argues that donors connect to a charity through a much more personal means than ratings and that few people take a clinical view and give by the numbers. Cochran also pointed out that Unitus' donors are generally motivated by effectiveness, which is the main flaw with ratings agencies: it is extraordinarily difficult to come up with a metric that says whether or not an organization is having an impact on the problem it is trying to address.

Though our interviewees were not entirely dismissive of the ratings, they tended to see low ratings or declines in ratings as a problem with the evaluation metric rather than with the organization, and they believe that the donors recognize such issues as well. The overall consensus of the organizations interviewed, therefore, was that nonprofits should be held accountable to donors and to the public but that the Charity Navigator ratings are too simplistic to effectively accomplish this goal. The oft repeated refrain was, "Charity Navigator ratings may accurately represent some types of organizations, but not ours." This sentiment cut across mission, scope, and organization size. Anne Knapp, in charge of Major Gifts, Foundations, and Planned Giving at the Woodland Park Zoo commented, "It is difficult to do things both simplistically and effectively." And, in her opinion, the simplicity of the Charity Navigator ratings impacts their effectiveness. Eastlake of the Delta Society agreed, saying, "It's tough to come up with a one size fits all set of measurements."

A point made by Cochran of Unitus sums up the overall dissatisfaction with the current nonprofit ratings systems: the ratings treat the nonprofit sector as an industry, something that would not be done in the for profit sector because it would not make sense to compare two very different businesses in the same way. Nevertheless, drastically different types of nonprofits, such as soup kitchens and zoos, are subject to the same metrics. Cochran argues that treating nonprofits as apples to apples when they are more like apples to motorcycles does a disservice to donors.

Thus, although the majority of charity watchdogs evaluate the financial practices of nonprofit organizations, financial practices do not appear to be the primary criteria that donors use to assess trustworthiness. Unless an organization's use of funding is extremely inappropriate and is therefore a statistical outlier, the ratio of funding spent on administrative versus programmatic costs or the percent of each dollar contribution spent on fundraising may not be of primary importance to most donors. For example, although newspapers have run numerous articles about accounting scandals in the nonprofit sector in the past few years, only a handful of nonprofits have been mentioned by name, and even those quickly and publicly reformed their accounting practices. In addition, some of the organizations that have been in the news because of financial scandals have been four star organizations, according to Charity Navigator.[27]

Consequently, when deciding to whom to contribute, donors place more importance on program content and outcomes or on the reputation of the organization in the community. We therefore conclude that changes in Charity Navigator ratings do not impact changes in primary revenue and contributions because for most donors, goodwill and reputation are a more important determinant of giving than financially based ratings. Our interviews suggest that donors believe that they already have sufficient information about their preferred charities without the input of Charity Navigator. Furthermore, as Williams pointed out, donors may not know what to make of the financially based ratings calculations, whereas volunteering and word of mouth recommendations may give them a sufficient understanding of program content and outcomes.

In sum, our interviews suggest that the importance that the nonprofits attribute to Charity Navigator ratings is limited; for donations, nonprofits rely much more on the ties that they have in the local and business communities. Moreover, nonprofits believe that community members who support their organizations have a more nuanced understanding of their work than the Charity Navigator ratings are able to convey. In other words, information asymmetries between the donors and nonprofits are not as severe as the academic literature suggests. Nonprofits put significantly more emphasis on goodwill and reputation in the community than they do on online ratings. As a result, for them it is not surprising that ratings do not impact donor contributions or primary revenue.[28]

[27] See North, Scott and Jackson Holtz. May 17, 2009. "Pasado's Safe Haven: Charity is a force for animals but critics question tactics, finances," and May 27, 2009. "Pasado's vows fight, faces new questions." Heraldnet.com: Snohomish County's Online News Source.

[28] In addition to information problems, there might be path dependencies in donation decisions. In exploring whether government subsidies crowd out provide giving, Horne et al. (2005) report that donors often do not know how much government subsidy a given non-profit receives, and only a few anticipate changing their donation decisions even when provided with such information.

Conclusion

Our article contributes to an important contemporary policy debate regarding the efficacy of new genre of governance mechanisms, information-based regulation. Policy and legal scholars recognize governance institutions can be supplied by both traditional governmental actors as well as non-governmental actors. Hence, there is considerable interest in understanding the contributions and limitations of non-governmental institutions in contemporary public policy and how these institutions relate to the traditional, government-supplied institutions. Indeed, in the last two decades, in addition to making governments more efficient and responsive to citizen's concerns via new public management (Hood 2007) and reinventing government (Osborne and Gaebler 1992), the subject of nontraditional forms of governance has emerged as an important topic in policy studies. Governance innovations such as voluntary programs and information-based regulations have attracted substantial policy and scholarly attention. In associated fields such as legal studies there is substantial interest in the issue of reflexive law as a response to the inadequacies of the traditional regulatory approaches in addressing the problems of modern societies (Teubner 1983).

New institutions have emerged to correct both governmental and market failures. There is less appreciation that these new tools themselves are vulnerable to institutional failures. While the literature on program or institutional efficacy is well developed in the context of voluntary programs, it is still in its infancy in the context of information-based regulation (probably the literature on the Toxics Release Inventory being an important exception). Our article contributes to this important but less studied issue in the context of information-based policies.

Charity watchdogs such as Charity Navigator can be viewed as an institutional response to governance challenges in the nonprofit sector. They are an important and visible part of the policy landscape that nonprofits have to negotiate. Importantly, they supplement state regulation because they draw upon the information that the nonprofits are required by law to annually report to the government. Charity watchdogs can therefore be viewed as regulation plus.

Charity Navigator constitutes an easy case to demonstrate the efficacy of information-based regulation especially in the context of the state of Washington. Given the widespread coverage of nonprofit scandals, donors have incentives to seek information on the charities they donate to, even the ones they are familiar with. In response to a market failure rooted in information deficits, charity watchdogs have emerged. The assumption is that because nonprofits seek to retain (and even expand) their donor base, the stick of withdrawing donation dollars or the carrot of infusing new donation dollars will create incentives for nonprofits to deploy resources as per their mandate.

In order to correct such market failure in the philanthropy market, Charity Navigator aims to provide financial information, free of cost, and in a user-friendly format. As noted before, it claims that a very high percentage of donors report that their charitable giving is influenced by ratings provided by Charity Navigator. Yet, we find that donor giving is not associated with changes in ratings provided by Charity Navigator.

Why might this be so? For information-based policies to be effective, external principals must be provided relevant information, act upon it in ways to embed the new information in their routine behavior, change their beliefs about specific nonprofits, and translate these beliefs into action. Charity Watchdogs assume that their charity ratings will constitute a key input in shaping donors' evaluation of nonprofits. The nonprofits we interviewed believe that even when donors follow charity ratings, these ratings do not significantly shape their perceptions of and eventual behavior towards nonprofits.[29] We speculate that donors tend to base their assessment of the trustworthiness of nonprofits on factors such as the reputation of the nonprofit. Consequently, the information deficits that charity watchdogs seek to mitigate might not be perceived as debilitating by a large percentage of donors. Of course, as rating systems mature, a larger percentage of donors might turn to them to get additional assurance. However, at this phase in their institutional development, it seems that nonprofit ratings are not influencing donor behavior.

Our findings should be interpreted with caution. First, charity ratings are one manifestation of information-based regulation which under certain conditions might be effective (Weil et al. 2006). Second, our empirical analysis is limited to only one state. Third, we have limited longitudinal data given that charity ratings are a recent institutional innovation. Arguably, over time, donors may begin to pay more attention to these ratings.

Furthermore, our article should also not be construed to suggest that online watchdog organizations do not enhance accountability. Although we find that charity ratings do not influence contributions, by enhancing the transparency of nonprofit accounting practices, they may preclude the misuse of funding that would have occurred in the absence of such transparency. Finally, it is possible that some specific types of donors are more responsive to watchdog ratings than others. A survey of donors to assess their use of and response to watchdog ratings is an area of future research.

Some efforts have already been made in the direction of improving nonprofit evaluation metrics. For example, in 2007, a panel on the nonprofit sector convened by Independent Sector published a "Principles for Good Governance and Ethical Practice" guide for charities and foundations. Charity watchdogs could also look to the systems that foundations already use to assess nonprofits. Or, nonprofit watchdogs could follow the lead of *U.S. News and World Report* and have nonprofits rate their peer organizations. It may also be the case that the most comprehensive ratings systems will require voluntary disclosure of information that goes beyond what is reported in the IRS Form 990. Voluntary regulatory programs have begun to appear, and this trend signals that responsible nonprofits would like to find ways to distinguish themselves from the mainstream. Therefore, future research on NGO accountability also lies in the direction of voluntary regulatory bodies which may be better able to evaluate the complexities of nonprofit organizations.

Finally, charity watchdogs need to incorporate the performance dimension in their ratings. Indeed, Ken Berger, President, and CEO of Charity Navigator (2009),

[29] We are not suggesting that citizens do not follow any ratings. Students often carefully follow the rankings of the university they are applying to (Espeland and Sauder 2007). Thus, it is important to appreciate the scope conditions of our argument.

recently noted: "Most exciting of all is our commitment to add a measure of outcomes to our rating system, which is going to take some time and hard work. A charity's ability to bring about long lasting, meaningful change for the better in the lives of the people and communities they serve should be the primary driver of charitable investments."

In sum, information-based regulation is neither a panacea nor a curse. While it is a promising approach to regulation, one needs to assess its fit with the institutional environment, the regulator, and regulatee characteristics. Both scholars and practioners should be conscious of the potential and limitations of any rating system. We hope our article will contribute to this policy dialogue.

Appendix 1: Rating Criteria

Charity Navigator rates organizations by evaluating their organizational efficiency and their organizational capacity.

Organizational Efficiency has five broad components: program expenses, administrative expenses, fundraising expenses, fundraising efficiency, and deficit adjustment. These categories are calculated as follows:

1. *Program Expenses*: program expenses divided by total functional expenses.
2. *Administrative Expenses*: compare administrative expenses to total functional expenses.
3. *Fundraising Expenses*: compare fundraising expenses with the charity's overall spending.
4. *Fundraising Efficiency*: determined by calculating how much each charity spends to generate $1 in charitable contributions.
5. *Deficit Adjustment*: when a charity runs a combined deficit over time, the efficiency score is adjusted downward.

If a charity spends less than a third of its budget on the programs and services it exists to provide, it is automatically given a score of zero for organizational efficiency.

Organizational Capacity has three broad components: primary revenue growth, program expenses growth, and working capital ratio, which Charity Navigator defines as follows:

1. *Primary Revenue Growth*: increasing contributions from corporations, foundations, individuals, and government grants; program service revenue, contracts and fees; and revenue from membership dues and fees.
2. *Program Expenses Growth*: growing programs and services.
3. *Working Capital Ratio*: reserves of liquid assets; includes cash, savings, accounts receivable, grants receivable, pledges receivable, investments in securities, accounts payable, accrued expenses, and grants payable; determined by how long a charity could sustain its current programs without generating new revenue; organizations with $250 million or more in working capital automatically receive full points in this category.

Both primary revenue growth and program expense growth are analyzed over the three to five most recent fiscal years. The overall rating combines the charity's performance in both efficiency and capacity. The final rating is also in part determined by comparing the individual charity's performance with the performances of similar charities. Further explanation of the methodology behind the ratings can be found on Charity Navigator's website (www.charitynavigator.org) under "Methodology."

Appendix 2: Model Variables

All of our data is taken from the Charity Navigator website. Charity Navigator derives its data from the IRS Form 990 s that tax-exempt nonprofits file.

Dependent Variables

Changes in primary revenue: Includes contributions, program services, and membership fees. We subtract 2006 primary revenue from 2007 primary revenue and divide the total by primary revenue in 2006.

Changes in contributions: We subtract 2006 contributions from 2007 contributions and, in order to account for differences in organizational size, divide the total by 2006 contributions.

Independent Variables

Charity Navigator Ratings: A combination of the *Organizational Efficiency* and *Organizational Capacity* ratings.

Organizational Efficiency:

Program Expenses: divides program expenses by total functional expenses.
Administrative Expenses: compares administrative expenses to total functional expenses.
Fundraising Expenses: compares fundraising expenses with the charity's overall spending.
Fundraising Efficiency: determined by calculating how much each charity spends to generate $1 in charitable contributions.
Deficit Adjustment: when a charity runs a combined deficit over time, the efficiency score is adjusted downward.
If a charity spends less than a third of its budget on the programs and services it exists to provide, it is automatically given a score of zero for organizational efficiency.

Organizational Capacity:

Primary Revenue Growth: increasing contributions from corporations, foundations, individuals, and government grants; program service revenue, contracts and fees; and revenue from membership dues and fees.
Program Expenses Growth: growing programs and services.
Working Capital Ratio: reserves of liquid assets; determined by how long a charity could sustain its current programs without generating new revenue;

includes cash, savings, accounts receivable, grants receivable, pledges receivable, investments in securities, accounts payable, accrued expenses, and grants payable; organizations with $250 million or more in working capital automatically receive full points in this category.

Changes in Fundraising Expenses: We subtract 2005 fundraising expenses from 2006 fundraising expenses and divide the total by 2005 fundraising expenses.

Net Assets 2005: Calculated by subtracting 2005 liabilities from 2005 assets and taking the log of the resulting value.

Longevity: Calculated by subtracting the year founded from 2006.

Scope: Coded 0 if the organization focuses on local outreach (city, state, or immediate region) and 1 if the organization focuses on national and international outreach.

Humanitarian: Coded1 if the organization conducts humanitarian work and 0 if the organization conducts non-humanitarian work.

Religious: Coded 1 if the organization has religious ties and 0 if it does not.

Animal: Coded 1 if the organization focuses on helping animal or training animals for disability services and 0 if it does not.

Policy: Coded 1 if the organization includes influencing public policy in its mission and 0 if it does not.

Art: Coded 1 if the organizations mission focuses on the arts and 0 if it does not.

Environment: Coded 1 if the organization's mission is primarily focused on environmental issues and 0 if it is not.

Education: Coded 1 if the organization's primary mission is to provide education and 0 if it is not.

Appendix 3: Case Selection

Ratings pattern	Organization	Scope	Mission	Size (net assets 2007)	Interview
Low ratings	Stronger Families (Redmond)	Local	Human services	$45,730	Michael Schindler, Development Director, December 18, 2008
High ratings	Mountains to Sound Greenway Trust (Seattle)	Local	Environ-mental	$1,852,961	Wendy Tyner, Development Director, January 27, 2009
Increase	Sightline Institute (Seattle)	Local	Policy	$1,872,125	Anna Fahey, Communications Strategist, February 27, 2009
Decrease	World Vision (Federal Way)	International	Human services	$151,403,054	Stephenie Williams, Director of Planning, Analysis & Reporting February 19,2009

continued

Ratings pattern	Organization	Scope	Mission	Size (net assets 2007)	Interview
High ratings	Woodland Park Zoo	Local	Animals	$15,645,528	Anne Knapp, Major Gifts, Foundations, and Planned Giving October 5, 2009
High ratings	Seattle Aquarium Society	Local	Animals	$3,564,601	Bob Davidson, CEO Lori Montoya, Director of Development September 22, 2009
Increase	Delta Society	National	Health	$7,296,889	Jon Eastlake, CFO August 21, 2009
High ratings	Unitus	International	Human Services—International	$10,357,604	Kate Cochran, VP External Relations September 16, 2009
Decrease	Humane Society of Tacoma and Pierce County	Local	Animals	$9,324,865	Marguerite Richmond, Director of Development August 19, 2009
Low ratings	Foundation in Seattle	International	Public Benefit	$44,141,404	Vice President for Finance & Administration August 21, 2009

Appendix 4: Descriptive statistics

Variable	Mean	Standard deviation	Min	Max
Change in contributions, 2006–2007	0.30	1.44	−0.86	12.21
Change in primary revenue, 2006–2007	5.46	21.20	–0.98	194.90
Change in overall rating, 2004–2005	0.04	0.83	–2.00	2.00
Change in efficiency rating, 2004–2005	−0.06	0.96	−4.00	2.00
Change in capacity rating, 2004–2005	0.04	0.96	−3.00	3.00
Changes in fundraising expenses, 2005–2006	0.11	0.35	−0.82	1.67
Net assets 2005 (logged)	14.75	3.14	0	19.81
Longevity	41.93	33.54	0	130
Scope	0.18	0.38	0	1
Type: Humanitarian	0.24	0.43	0	1
Type: Religious	0.06	0.24	0	1
Type: Animal	0.08	0.28	0	1
Type: Public benefit	0.18	0.38	0	1
Type: Art	0.15	0.36	0	1
Type: Education	0.08	0.31	0	1
Type: Environmental	0.11	0.31	0	1
Type: Health	0.09	0.29	0	1

Interview Questions

What do you know about nonprofit ratings systems and are you familiar with Charity Navigator?
Do you know what the current rating for your organization is on Charity Navigator or any other nonprofit rating system?
Does your organization systematically track ratings?
Have the changes in your ratings over the past few years affected your organization, and if so, how? Do negative ratings harm donations? Do positive ratings improve donations?
Has your organization made changes based on the nonprofit ratings? If so, what kind?
What influence do nonprofit ratings systems have on your donors? Do they impact your reputation among donors?
What impact do you think they have on donors to other types of organizations?
Which factors motivate your donors to give?
In what ways does the reputation of your organization in the community impact your organization?
How does your organization seek to differentiate itself to donors?
Do you think the ratings are accurate and fair?
What information would ratings ideally convey?

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