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A theory of outsourced fundraising: Why dollars turn into "Pennies for Charity"☆

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ABSTRACT

Charities frequently rely on professional solicitors whose commissions exceed half of the solicited donations. To understand this practice, we propose a principal-agent model in which the charity optimally offers a higher commission to a more efficient solicitor, raising the price of giving significantly. Outsourcing is, therefore, profitable for the charity only if giving is very price-inelastic, which is not supported by empirical evidence. We show that outsourced fundraising can be optimal if: donors are unaware of this practice; the professional solicitor better activates donors' warm-glow feelings toward the cause; or there is a significant fixed cost of fundraising. We argue that informing the public of the mere existence of paid solicitations may be the most effective policy available.

1. Introduction

Fundraising is essential to most charities – but it is costly. A 25–35% cost-to-donation ratio is considered reasonable by leading experts (Kelly, 1998) and watchdogs such as Charity Navigator. This benchmark is, however, significantly exceeded by those charities that rely on professional fundraisers.[1] According to the "Pennies for Charity" reports of New York state, charities regularly paid more than half of the solicited donations to telemarketing companies; see Fig. 1 based on the 2013 report.[2]

The cost of paid fundraisers raises legitimate concerns about the accountability of charitable organizations. As such, it has the potential to undermine public confidence in the entire nonprofit sector, which constitutes about 2% of GDP in the U.S. (List, 2011). Complicating policy is the fact that regulation of fundraiser fees *and* their disclosure to donors is unconstitutional

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[1] "Professional fundraiser" is a legislated term often used for a third-party whose services are contracted for. This term excludes employees of the charitable organization (Hopkins, 2009).

[2] The *Pennies* reports are available at <www.charitiesnys.com>.

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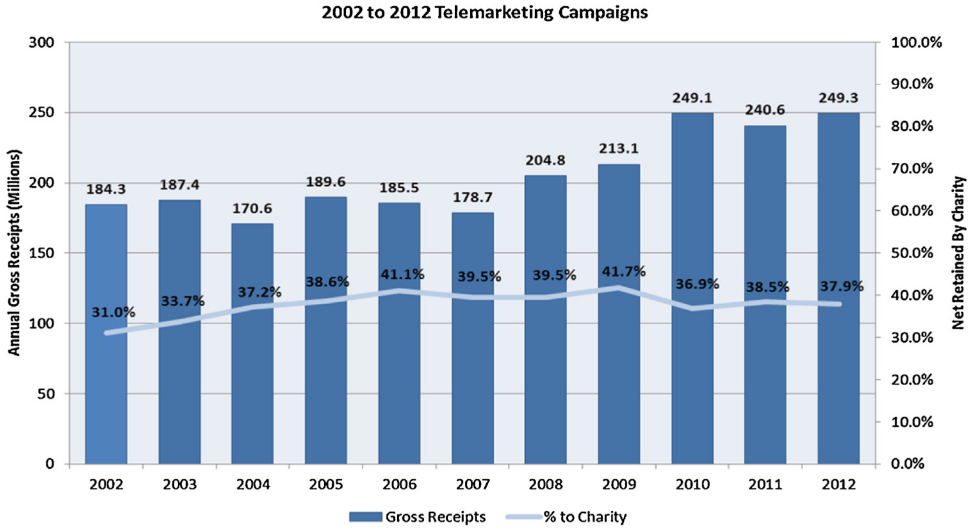

Fig. 1. Charitable telemarketing in New York.

(Hopkins, 2009).[3] Therefore, the most state regulators can do are to compel paid solicitors to identify themselves to donors and to publish their campaign statistics (Fishman and Barrett, 2013).

This paper offers a first analysis of outsourced fundraising: why it exists despite being so expensive and what it implies about donor motives and policy.[4] Our base model features one charity, one professional fundraiser and many identical donors with standard, purely altruistic preferences. Each donor gives only if solicited.[5] The charity may conduct these (costly) solicitations on its own or outsource them to the professional by promising him a percentage of the donations collected. We find that it is hard to rationalize outsourcing in this standard setup if, as required by law, the professional reveals himself to donors. Intuitively, under outsourcing, the charity retains the paid solicitor as an agent whose unobserved effort is the number of solicitations (Holmstrom, 1979). To overcome the resulting incentive cost, the charity outsources only if the paid solicitor is sufficiently more "efficient" than itself. Consistent with agency theory, the charity must then optimally offer a high percentage of total receipts to such an efficient solicitor, implying a high price of giving for donors. Outsourcing is, therefore, profitable for the charity only if giving is very price-inelastic. That, however, is refuted by empirical evidence on elasticity (Clotfelter, 1985; Randolph, 1995; Auten et al., 2002; Eckel and Grossman, 2003; Bakija and Heim, 2011; Huck and Rasul, 2011) as well as lab data on preferences for giving (Andreoni and Miller, 2002; Fisman et al., 2007).

In light of this (negative) finding, we offer three explanations for outsourcing. First, despite state disclosure laws, donors may still be unaware of paid solicitations and continue to give generously. This is consistent with the anecdotal evidence presented in media reports[6] as well as survey evidence indicating largely uninformed giving (Hope Consulting Report, 2011) and the strong public confidence in the charitable sector (O'Neill, 2009; Edelman Trust Barometer, 2014). Second, the professional solicitor may be better trained in activating "warm-glow" feelings (Andreoni, 1989) toward the cause, making donors less sensitive to the increased price of giving. And third, the fundraising campaign may simply involve too high a fixed cost for the charity but not for the professional fundraiser.

As a by-product, our analysis reveals that a more efficient charity that raises greater (net) funds may also score a higher cost-to-donation ratio, which supports the critics of charity ratings based on this ratio (Steinberg, 1991; Karlan, 2011). In two extensions of our model, we further show that charities may view paid solicitations as an "investment" into acquiring new donors,[7] and that charities with additional revenue sources such as product sales, fees, government grants or repeat donors are less likely to use paid solicitors.

Apart from the papers mentioned above, our paper relates to a growing theoretical literature on strategic fund-raising by means of: coordinating donations (Andreoni, 1998; Marx and Matthews, 2000); facilitating informed giving (Vesterlund,

[3] Citing freedom of speech (about charitable causes), the U.S. Supreme Court ruled such regulation unconstitutional in three landmark cases: Village of Schaumburg v. Citizens for Better Environment, 444 U.S. 620 (1980); Secretary of State of Maryland v. Munson Co., 467 U.S. 947 (1984); and Riley v. National Federation of the Blind, 487 U.S. 781 (1988).

[4] Starting with Coase (1937), the issue of internal vs. external operations of organizations has been extensively studied in the literature; see Williamson (2005) for a survey. Our paper differs in its focus on nonprofits.

[5] Directly asking donors is considered one of the most powerful fundraising techniques; see, e.g., Meer and Rosen (2011) and Edwards and List (2014) for recent evidence.

[6] See <www.bloomberg.com/news/2012-09-12/charities-deceive-donors-unaware-money-goes-to-a-telemarketer.html> and <www.tampabay.com/americas-worst-charities>.

[7] The *Pennies* reports indicate that about 10% of telemarketing campaigns result in a loss for charities.