



Information, competition, and the quality of charities[☆]



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ABSTRACT

Drawing upon the all-pay auction literature, we propose a model of charity competition in which informed giving alone can account for the significant quality heterogeneity across similar charities. Our analysis identifies a negative effect of competition and a positive effect of informed giving on the equilibrium quality of charity. In particular, we show that as the number of charities grows, so does the percentage of charity scams, approaching one in the limit. In light of this and other results, we discuss the need for regulating nonprofit entry and conduct as well as promoting informed giving.

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1. Introduction

Up 30% from a decade ago, the number of public charities in the United States exceeded one million in 2013 (Urban Institute, 2014).¹ Charity Navigator, the leading charity evaluator, offers free ratings of the largest 8000 by identifying 37 causes (e.g., humanitarian relief). Its ratings reveal that the quality of the charities within each cause varies significantly with about one-third failing industry standards.² The challenge for donors is therefore not finding a worthy cause

to support but choosing the charity that is most deserving of their hard-earned money. Despite its importance, however, informed giving appears to be the exception rather than the rule.³ In this paper, we propose a model of charity competition in which informed giving alone can explain the quality heterogeneity across similar charities. Our analysis highlights an adverse effect of competition and a beneficial effect of informed giving on the quality of charity.

Our baseline model contains a fixed number of *ex ante* identical charities that fundraise for a given cause by declaring their specific missions (e.g., helping children and improving women's health) and pre-investing in their program and service quality such as infrastructure, planning, and staff training.⁴ We assume that while

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¹ Public charities constitute about three-quarters of all registered nonprofits in the U.S., and unlike other nonprofits such as private foundations, they rely heavily on contributions from the general public, which consistently total about 1.5% of GDP in the U.S. – \$241.3 billion in 2013. In this paper, we mainly focus on public charities and use the term nonprofit interchangeably.

² For details, visit www.charitynavigator.org. Significant quality variation is also reported by other major charity evaluators including BBB Wise Giving Alliance and GuideStar. Not surprisingly, it is such variation that has facilitated recent empirical investigations of charity ratings (e.g., Yörük, 2016).

³ Based on a nationwide survey of 4000 Americans with incomes in the top 10%, the 2010 Hope Consulting Report found that 9 out of 10 donors indicate that they care about nonprofit performance, but only 3 out of 10 donors actually research nonprofits and only 3 out of 100 ensure giving money to highest-performing nonprofits; see www.hopeconsulting.us/moneyforgood. Experimental evidence parallels this finding: whereas Eckel and Grossman (1996) document that individuals give generously when they are paired with recipients of preferred characteristics, Fong and Oberholzer-Gee (2011) observe that only one third of subjects are willing to pay for information about recipients.

⁴ Given that charitable contributions are often nonrefundable, donors are unlikely to find any promised and/or uncertified quality credible.

some donors are purely mission-oriented, others care about quality. Among the latter, informed donors seek the best charity, perhaps using a rating agency, whereas the uninformed pick one at random. Note that the presence of mission-based and uninformed giving in the population invites charity scams: fundraising with no intention of providing the public good. Hence, in our model, charities invest in quality to attract informed donations. And their incentives to “win” a lump-sum revenue by setting a slightly higher quality than the rivals’ turn the charity competition into an “all-pay auction” and leads to mixing over quality choices in equilibrium.

In the unique symmetric equilibrium, we establish that each charity continuously mixes over a positive interval of quality and has a mass point at zero. Such a strategy readily rationalizes the quality heterogeneity mentioned above and predicts a significant probability of charity scams. We show that by raising the stakes for being the best charity, informed giving (stochastically) increases the equilibrium quality of charities, and individual informed and uninformed gifts in turn. Nevertheless, the total provision of the public good is likely to be maximized when there is an optimal mix of the two donor types in the population: with too many informed donors, charities compete away donations in the “race to the top”, while with too many uninformed, they have little incentive to offer (costly) quality, which would discourage giving. This implies that the total provision improves with informed giving if the initial level of informed giving is low, which seems to be the case in reality (see Footnote 3).

The positive effect of informed giving is, however, countered by the negative effect of charity competition. Most starkly, we prove that as the number of charities grows unbounded, the fraction of scammers in the economy approaches one, owing to a negligible probability of receiving the informed donations.⁵ Our analysis, therefore, suggests regulating the market structure of the nonprofit industry. As discussed in Section 5, this can be achieved by setting higher entry barriers, such as a more onerous application procedure for tax-exempt status, or providing stronger incentives for nonprofit mergers, such as funding their due diligence. Our analysis also suggests regulating charity conduct and sanctioning poor performers, although in practice nonprofit enforcement is bound to be too weak to completely deter charity scams because of the legal and financial obstacles that regulators have to overcome.

The policy implications of our baseline model are reinforced in the long run market with an endogenous number of charities. In particular, introducing a costly entry stage to the model, we find that only the best charity provides the public good in the long run, with many unsuccessful and/or scam organizations present. The reason is that under endogenous entry, charities exhaust what they expect to receive from the unsuspecting – mission-oriented and uninformed – donors, leaving only the informed donors as their source of a positive net revenue. Similar to the baseline model, this means that the nonprofit market is likely to be highly concentrated in the provision of the public good, as evidenced by Seaman et al. (2014) and discussed in Section 5.

1.1. Related literature

Our theoretical framework draws upon two influential papers on all-pay auctions: Varian (1980) and Che and Gale (2003). Varian considers a price competition with informed and uninformed consumers in order to explain equilibrium price dispersion. Roughly speaking, a price reduction in Varian’s model plays a similar – investment – role to a quality increase in ours, although unlike quality, a price change does not affect consumers’ reservation utility in Varian (1980). Che and Gale (2003) examine a research tournament where there is only

one buyer, the procurer, whose value of innovation is endogenous to the winner’s effort and who decides informed. Siegel (2010) ably generalizes such all-pay auctions with endogenous valuations.

On the nonprofit side, our paper relates to the few studies on charity competition.⁶ Rose-Ackerman (1982) shows that competitive fundraising can be “excessive” despite donors’ aversion to it. Castaneda et al. (2008) argue that such inefficiency may be reduced by nonprofits’ ability to contract on the use of donations while Aldashev et al. (2014) observe that it can be overcome by fundraising coordination, though such coordination is often difficult in this voluntary sector. In the same vein, Bilodeau and Slivinski (1997) find that rival charities may specialize in the provision of one public good or service in order to attract donations. With over one million registered charities, there are nevertheless many that provide similar – if not identical – services yet differ significantly in their quality of provision. In this sense, Scharf (2014) is closer to our work. Assuming an exogenous quality distribution, Scharf points out that competition can induce too much entry by low quality charities. We let quality choice be part of the competition and derive an endogenous distribution for it. Like her, we argue that increased entry into the charitable market decreases the (average) quality of charity.

On the role of informed giving, our paper also relates to Andreoni (2006), Vesterlund (2003) and Krasteva and Yildirim (2013). Vesterlund shows that a large leadership gift can signal the (exogenous) quality of the charity. Andreoni extends this argument by demonstrating that all else equal, it is the most wealthy who will lead. Krasteva and Yildirim explore a private value setting in which donors are uncertain about their private valuations of the charity and thus no signaling incentive exists. In all these papers, informed giving raises more funds on average and is therefore uniformly encouraged. In contrast, our analysis emphasizes that both informed and uninformed giving might be important for the performance of the charitable market.

The rest of the paper is organized as follows. In the next section, we present the baseline model with an exogenous number of charities and exogenous donor information. In Section 3, we characterize the equilibrium and consider key comparative statics, followed by several extensions of the model in Section 4. In the last two sections, we discuss the empirical and policy relevance of our findings and then conclude with final remarks. The proofs of all formal results are relegated to Appendix A.

2. Baseline model

There are $n \geq 2$ *ex ante* identical charities raising funds for a given cause such as humanitarian relief. Before appealing to donors, charities publicly announce their specific missions (e.g., helping children and improving women’s health) and simultaneously invest in their program quality $q_i \in [0, \infty)$ that costs $C(q_i) = q_i$.⁷ Unlike their missions, the charities’ quality is observed by donors only upon inspection, possibly through a rating agency, and it may reflect the investment in infrastructure, planning, and staff training, for instance. Let $\mathbf{q} = (q_1, \dots, q_n)$ and $G_i(\mathbf{q})$ denote the quality profile of charities and the total gift received by charity i , respectively. Conjecturing the rivals’ quality profile \mathbf{q}_{-i} , charity i chooses q_i to maximize its net revenue to be spent toward its program:

$$R_i(\mathbf{q}) = G_i(\mathbf{q}) - C(q_i).$$

⁶ For a recent overview of the literature on charitable giving, see Andreoni and Abigail Payne (2013).

⁷ As previously mentioned, most charitable contributions are nonrefundable; hence, fearing hold up, donors are unlikely to trust any promised and/or uncertified quality by charities. Our results are, however, robust to “partial” promises, whereby, as in Siegel (2010, Section III), the charity invests a fraction of q_i , with the commitment of investing the rest if enough funding is received.

⁵ In the limit economy, the expected number of nonscam charities is nonzero and finite.

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