The club framework

1 Voluntary regulation of NGOs and nonprofits: an introduction to the club framework

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The global nonprofit and nongovernmental (NGO) sector has expanded substantially during the past two decades.[1] As a result of this "global associational revolution" – marked by massive infusion of funds from governments, international organizations, foundations, and individuals – the nonprofit sector became a major component of the social service delivery system in most countries (Salamon *et al.*, 2003; Salamon, 1994). This growth also thrust nonprofits and NGOs into the middle of contemporary policy debates over the appropriate role for governments and markets in the provision of public services (Giddens, 1998; Anheier and Salamon, 2006). With this expansion, the nonprofit sector also became a target for increased scrutiny, in part because it appeared to attract "bad apples" along with well-intentioned, principled organizations. Scandals and charges of nonprofit mismanagement and misappropriation have been extensively covered by the media (Fremont-Smith and Kosaras, 2003; Gibelman and Gelman, 2004; Greenlee *et al.*, 2007).[2] As a result, nonprofits face growing demands for accountability from resource providers as well as from the constituents they claim to serve (Edward and Hulme, 1996; Spiro, 2002; Brody, 2002; Ebrahim, 2003).

While scandals tend to impose costs on the specific wrongdoers, they can muddy the reputation of all actors with similar sectoral scope or organizational characteristics. Indeed, high-profile cases of governance failure have tended to impose negative reputational externalities on all

[1] Since both nonprofit and nongovernmental organizations (NGOs) are subjected to the nondistribution constraint – they cannot distribute profits to their principals or owners – we use the term nonprofit for both types of organizations. This chapter draws on Prakash and Gugerty (2010).

[2] Nonprofits are also criticized for accentuating "democracy deficits" by providing public goods and advocating on behalf of constituents without publicly elected leadership, especially if they appear to be substituting for democratically elected governments. This volume does not examine this issue. We focus on voluntary programs which have emerged in this sector in response to perceived governance failures.

nonprofits. A recent global opinion survey found that in a number of countries worldwide, the nonprofit sector is now less trusted than government or business (Edelman Trust, 2007). Public scandals may undermine the credibility of nonprofits as a category of actors, thereby reducing the ability of credible nonprofits to raise funds and to function with a reasonable degree of autonomy. Scandals can also attract the interest of regulators, who come under increased pressure to "do something" about the problem. In the United States, corruption and governance scandals in the for-profit and nonprofit sectors led to increased Congressional scrutiny of the regulatory framework governing the nonprofit sector (Independent Sector, 2005, 2007). In many developing countries, rapid growth in the nonprofit sector combined with weak regulatory institutions have spurred government initiatives to increase regulatory authority over nonprofits, often with the intent of controlling or curtailing what is viewed as political activity (Gugerty, 2008). Thus, credible nonprofits – the good apples – can be expected to seek ways to differentiate themselves from the bad apples and credibly to signal their commitment towards good governance to their funders, authorizers, and supporters. This volume examines how voluntary accountability clubs might be employed, successfully as well as unsuccessfully, as institutional vehicles for this task.

We begin this volume with the premise that the accountability challenges nonprofits face can be viewed as agency problems between nonprofits and their stakeholders, or principals. Given the widespread perceptions of such agency conflicts, the challenge for "good" or "credible" nonprofits is to demonstrate to their resource providers and authorizers that they are governing as agreed and delivering as promised. Multiple principals, legal as well as constructed, make accountability claims on nonprofits and these claims may not always cohere, thereby accentuating agency problems (Mahon, 1993).[3] Thus, nonprofits need to decide which of these claims to address and through what mechanisms.

Scholars, policymakers, and nonprofits themselves have invested considerable effort in identifying appropriate and effective oversight and governance mechanisms to mitigate agency conflicts and make nonprofits more accountable. Potential policy options include increased government regulation (including more stringent operating and reporting requirements), self-regulation through industry associations, and the use of

[3] Agency relationships can be formal and legal. Here, the principals have legal course to shape the activities of their agents. In some other cases, a given set of actors may construct themselves as principals of some other actors. While such constructed principals might not be able to make legal claims on their agents, they may still be able to shape agents' behaviors by imposing costs and bestowing benefits.

private accreditation or certification mechanisms. This volume examines the role that voluntary programs, defined as rule-based systems created and sponsored by nongovernmental actors, can play in mitigating agency conflict and resolving agency dilemmas between nonprofits and their principals. We conceptualize these programs as "clubs," in the political economy sense of the term (Prakash and Potoski, 2006). While the club framework has been employed to study voluntary programs among for-profit firms (Potoski and Prakash, 2009b), this is the first book to apply the framework systematically in the context of the nonprofit sector. In doing so, we also extend the club perspective and build on previous studies of nonprofit voluntary programs (Gugerty, 2009) by bringing in agency theory to explore how principal–agent dynamics influence club emergence, design, participation, and efficacy.

Nonprofit accountability clubs are rule-based institutions that create standards for behavior, regulate membership, and enforce compliance among members. In some cases, they offer certification or formal accreditation. The number of these programs is on the rise (Bothwell, 2001; Sidel, 2003; Lloyd, 2005; Lloyd and de las Casas, 2005). According to One World Trust, more than three hundred nonprofit codes of conduct and standard-setting programs exist globally (Warren and Lloyd, 2009). Gugerty (2009) examines thirty-two programs in operation globally; Sidel (2003) documents seventeen programs in Asia alone. Voluntary programs can take a number of different forms including self-regulatory collectives, third-party accreditation programs, or industry association-sponsored programs. We argue that underlying this apparent institutional diversity is a set of common collective action challenges, and that these voluntary programs constitute a common institutional response to these challenges. Below we outline how a deductive, theoretical perspective derived from agency and club theory can add to the study of voluntary programs among nonprofits. Our objective is to develop a generalized approach that can help accumulate knowledge about nonprofit accountability programs across a range of settings.

Accountability and agency in nonprofit organizations

In this volume we argue that agency dilemmas are at the heart of challenges to nonprofit accountability. An agent is an actor who is expected to act on behalf of a principal (Mitnick, 1982). Agency conflicts arise when agents do not act according to the wishes of the principals. Instead, they act in response to their own preferences, which may not align with those of the principals (Berle and Means, 1932; Ross, 1973; Mitnick, 1982; Fama and Jensen, 1983; Moe, 1984; Wood, 1988; McCubbins *et al.*, 1989; Waterman and Meier, 1998; Shapiro, 2005). An agency view of accountability implies that some actors possess the right to hold other actors to a set of given standards, to judge their performance in meeting those standards, and to take action if standards are not met (Edwards and Hulme, 1996; Grant and Keohane, 2005). Thus accountability relationships involve three components: agreement or recognition of standards for behavior, information about actual behavior, and the ability to judge performance and hold actors to account (Rubenstein, 2007). We view accountability as a set of relationships and this differentiates our view from other definitions that focus on accountability as a process, as, for example, the process by which public agencies manage diverse stakeholder expectations (Romzek and Dubnick, 1987). This also makes accountability relationships, which are judged after the fact, distinct from the institutional structures or "checks and balances" that are designed to prevent malfeasance in the first place (Grant and Keohane, 2005). Of course, such institutional structures are a response to accountability relationships, and, in a dynamic setting, actors are likely to anticipate accountability demands and engage in institutional design to address the concerns of principals – indeed such behavior is the subject of this volume.

In the agency model of accountability, agents are empowered to undertake tasks on behalf of principals and are expected to fulfill the wishes of principals. These wishes can be specified through a specific contract or set of standards agreed upon between the agent and the principals or can be based on commonly accepted standards for professional behavior.[4]

Our perspective on accountability can be distinguished from several other approaches, including organizational ecology, resource dependence, stakeholder theories, and semiotic approaches. From an organizational ecology perspective, accountability is a narrative process. It is the way in which organizations account rationally for their actions: how they document their use of resources and construct logical sequences of decisions, rules, and actions – whether truthful or not (Hannan and Freeman, 1989). The demand for these "accounts" arises from norms of procedural rationality in which legitimacy (defined as the probability that external actors will endorse an organization's actions) depends on the appearance of

[4] Some strands of the accountability literature distinguish between delegation and trusteeship as distinct forms of accountability (Grant and Keohane, 2005) or highlight distinctions between hierarchical, electoral, legal, and professional forms of accountability (Romzek and Dubnick, 1987). We retain the focus on the core characteristics of all forms of accountability in our definition: standards, information, and sanctions. While specific accountability relationships such as trusteeship or electoral accountability may give rise to different institutional mechanisms for setting standards, delivering information, or undertaking sanctions, the need for each of the three mechanisms is common to all accountability relationships.

conformity to these norms. Accounts reassure investors and supporters that they are not wasting their time, effort, or resources. Since organizations are in a competition for survival, those organizations that can repeatedly produce credible accounts will be more likely to survive. From this perspective, the key attributes of accountability valued by principals are predictability and reliability.

Resource dependency approaches highlight the social control that resource-holding organizations can exert over others (Pfeffer and Salancik, 1978). When the resource is critical to the consuming organization and few substitutes are available, the resource-holding organization may be able to exert strong influence over the resource-consuming organization. Consequently, the consuming organization will be willing to spend a great deal of time and effort complying with the demands of the resource provider. Of course organizations that are dependent on a large number of external organizations may face conflicts in this regard. Resource dependency suggests that key resource providers will be important principals for any organization, but resource-based relationships comprise only one set of potential accountability demands. Stakeholder perspectives on for-profit firms (Freeman, 1984) expanded the list of potential principals who could make claims on an organization by extending beyond those principals who have ownership authority over an organization. Stakeholder approaches suggest that nonowner actors may construe themselves as principals of organizations (although they may make these claims with varying success; Mitchell *et al.*, 1997). When such actors have the ability to exert influence by withholding or granting legitimacy or reputation, organizations have every incentive to heed their claims. While both resource dependency and stakeholder approaches highlight the potential for multiple principal problems, neither approach privileges the role of information problems in creating the potential for agency abuse. This is the unique contribution of agency theory.

Finally, our agency perspective on accountability should be distinguished from semiotic approaches that view accountability as a symbol and a sign, a form of "political theater" that is pluralistic, constantly renegotiated, and not amenable to systematic definition (Ebrahim and Weisband, 2007). We find the theater analogy interesting, because to assess the complexity of accountability one needs to identify the key actors (who is accountable to whom, why, and through what mechanisms). While we favor clearly defining accountability in terms of standards, information, and sanctions, we recognize that accountability involves relationships of power. As a result, accountability is not normatively "good" in and of itself, that is, more "accountability" (or more rules and procedures) is not necessarily better for all actors. Indeed, as we point out later in this introductory chapter, an important motivation for the emergence of accountability clubs is the desire to preempt more intrusive demands from resource providers for information on how nonprofits are deploying resources.

The advantage of an agency perspective as a starting point for thinking about accountability lies in the parsimonious framing of the relationships among nonprofits and those that entrust them with authority and resources. Accountability is a contested concept and nonprofits, like other organizations, are often engaged in strategic efforts to manage their accountability relationships with others (Kearns, 1994). Indeed, we argue that participation in accountability clubs is a strategy on the part of nonprofits to manage, and even shape, their accountability relationships. We conceptualize nonprofits as agents charged with undertaking specific activities on behalf of various principals, particularly donors and governments. Agency dilemmas among nonprofits, as with other kinds of actors, may arise when the preferences of nonprofits (more specifically, preferences of the key individuals who manage them) diverge from those of donors or other principals, when the preferences of principals are not clearly defined, or when the preferences of multiple principals are in conflict.

Preference substitution is perhaps the most common agency dilemma among nonprofits. Governments are increasingly charging nonprofits to provide a variety of public services, but many governments possess very weak regulatory and oversight mechanisms with which to ensure that their mandates are fulfilled. Private donors often provide funding to nonprofits to undertake specific activities in areas such as education, public health, environment, women's empowerment, and economic development. While they expect nonprofits to spend these resources judiciously and effectively to deliver services to the target populations, they often do not have the capacities to monitor nonprofits' operations adequately. Citizens provide resources to advocacy nonprofits with the expectation that they will effectively advocate issues which the citizens care about. Again, they do not have the resources or the willingness to monitor how their funds have been spent. In sum, inadequate monitoring creates opportunities for nonprofits to engage in preference substitution. Nonprofits may also engage in preference substitution when the goals of various principals conflict, a point we return to below.

Principals may be inclined to provide resources to nonprofits to undertake desired services for two reasons. First, principals may favor the pursuit of specific objectives (often the amelioration of specific government and market failures) but may not have the competencies to undertake this activity themselves. They recognize that with their field-level knowledge, nonprofits are better positioned to serve such objectives. Second, in relation to for-profit firms and governments, principals may view nonprofits as more "trustworthy" actors, where trust is understood as the belief that agents will undertake activities as promised and will not engage in deliberate strategic behavior that undermines the interests of principals. The literature suggests that nonprofits may be viewed as trustworthy because they are constrained from distributing profits to owners – the assumption being that the generation and appropriation of profits makes actors do "bad things" such as cutting back on quality in order to increase profits (Hansmann, 1980; Rose-Ackerman, 1996). Thus, nonprofits are deemed trustworthy not necessarily because of what they do but because of their institutional design. The absence of the profit motive may be particularly important when organizations produce "credence" goods whose quality is difficult to observe even after purchasing. Of course, governments do not generate or distribute profits and yet trust in governments is highly variable across countries. Indeed, the literature recognizes that trust may not be a sufficiently robust basis for contracting (Ortmann and Schlesinger, 2003), particularly when principals – such as institutional donors and governments – are themselves accountable to others for demonstrating results. Moreover, the nondistribution constraint will tend to constrain only one form of opportunism: strategic behavior designed to increase profits (Ben-Ner and Gui, 2003). Other forms of opportunism may remain. Even in the absence of outright fraud, nonprofits may suffer from "goal displacement" or "mission drift" in which nonprofits operate according to the preferences of managers and boards (themselves unelected), while disregarding the preferences of funders, beneficiaries, or government authorizers (Steinberg and Gray, 1993; Ortmann and Schlesinger, 2003).

Agency concerns are not only the purview of principals – strategic preference substitution on the part of some nonprofits may harm other organizations operating in the same sector as well. As in any other category of collective actors, there are "good" and "bad" nonprofits. There is no evidence to believe *ex ante* that the nonprofit sector is more (or less) prone to agency failure than the public or commercial sectors. However, if there is a nontrivial percentage of "bad apples" (which could mean corrupt or merely ineffective organizations) in the pool of nonprofits, principals have an incentive to identify these bad apples to avoid supplying them with resources. If principals are unable to distinguish between "good" and "bad" nonprofits, they may begin to view all nonprofits with more caution, perhaps even suspicion. In extreme cases, they may become wary of providing any resources lest they fall into the wrong hands. The inability to differentiate nonprofits may depress the overall volume of resources principals are willing to provide to nonprofits, an issue that is extremely worrisome in the current economic climate. Some studies suggest that in the United States, the cost of this reduction in resources may be as much as $100 billion a year (Bradley *et al.*, 2003). Many nonprofits, including the good ones, may be forced to exit the market, or curtail the scale or scope of their activities, a situation that neither the principals nor the nonprofits desire. These dynamics are analogous to the market for lemons described by Akerlof (1970). When there are information asymmetries between the buyer (principal) and the seller (nonprofit), and heterogeneity in quality of the seller, bad sellers can eventually drive good sellers out of the market.

But even if every nonprofit is "good" and seeks to follow principals' preferences, goal conflict among multiple principals can give rise to similar agency dilemmas. Governments may care more about equity in the provision of nonprofit services, while institutional donors may care more about responsiveness to their particular constituency (Smith and Lipsky, 1993). When each principal has a distinct contract with the nonprofit, these contracts may differ substantially in their goals. Nonprofits might not be in a position to order these competing demands. In response, they may seek to adequately satisfy several constituencies. When principals are unable to observe whether nonprofits are adequately addressing their concerns, however, they may again be reluctant to provide resources.

Thus the presence of information asymmetries and multiple principals in the nonprofit sector may result in increased inefficiencies, as a result of agency costs or agency slippages. To combat information deficits, principals may stipulate extensive reporting requirements and oversight mechanisms. Furthermore, principals may begin to make only small, short-term grants to nonprofits as opposed to larger, long-term ones.[5] Given the difficulties in observing nonprofit quality, principals are likely to create reporting requirements that are appropriate for the "average" nonprofit. Consequently, the good nonprofits are likely to be overregulated while the bad ones are likely to be underregulated. Adverse selection problems may follow. If the heterogeneity among nonprofits is substantial, bad nonprofits might even drive good nonprofits out of the funding market. Even if this dire prediction does not come true, agents will be forced to devote an increasing share of their resources to governance and oversight rather than to program implementation. Particularly good nonprofits that attract funding

[5] Another option might be for principals to establish ongoing, collaborative oversight and reporting arrangements with funded organizations; this is the "venture philanthropy" model. Such relationships may help mitigate agency conflicts, but given that the number of such relationships that any one principal can undertake will be limited, it may still have the effect of depressing the overall amount of funding available to nonprofits.

from multiple sources may find themselves facing especially high administrative costs; many nonprofits argue that multiple reporting requirements consume a great deal of organizational time and energy (Ebrahim, 2005). Short-term funding may lead nonprofits to prioritize short-term projects, where benefits can be demonstrated more quickly, over long-term projects, which might have a greater impact but only in the long run (Henderson, 2002). In sum, in response to agency conflicts rooted in information asymmetries, principals may reduce the supply of resources to nonprofits or increase governance costs that constrain nonprofits' effectiveness.

The anticipation of "market failure" in the philanthropy market gives "good" nonprofits the incentive to address accountability concerns proactively. Nonprofits may voluntarily establish (or join) mechanisms that supply informational signals about their internal governance and activities to their principals, along with providing assurances that nonprofits are making serious efforts to conform to the objectives set by the principals. By doing so, nonprofits hope to obtain an ongoing or increased supply of donor funds, greater operational freedom, and decreased governance costs. Further, their proactive voluntary regulation might dampen the demand for new laws that restrict their activities in even less desirable ways. The next section examines the agency dilemma faced by nonprofits and their principals in more detail and suggests some ways in which voluntary accountability programs among nonprofits may address these dilemmas.

Agency dilemmas among firms and public bureaucracies

Principal–agent theory derives originally from theories of the firm in which principals wish to contract with agents to carry out specific tasks (Alchian and Demsetz, 1972; Holmstrom, 1982). Problems can arise because principals can observe only outcomes and not the full effort of agents. If unanticipated or unwanted outcomes are observed, principals may have difficulty distinguishing the extent to which bad luck or malfeasance contributed to the outcome. To overcome these obstacles, principals can attempt to write detailed contracts, but contracts typically cannot cover all contingencies. Principals can engage in costly monitoring, but will likely always face some agency losses because of asymmetric information. Principals may therefore attempt to minimize these losses using additional mechanisms, including screening and selection of agents prior to contracting or institutional design that includes built-in checks and balances (Kiewert and McCubbins, 1991).

Among firms, shareholders, as providers of capital, are the principals who attempt to exercise control over the agents (managers) through the board of directors. While the firm is accountable to several "stakeholders"