

Certification As A Viable Quality Assurance Mechanism in Transition Economies: Evidence, Theory, and Open Questions¹

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Abstract

Traditionally, enforcement of (consumer protection) laws meant to provide quality assurance of goods and services was considered a responsibility of the state in its various guises (e.g., national government, regional government, local government). Unfortunately, enforcement is an expensive, and hence particularly problematic, proposition in transition economies that have many competing demands on their very scarce resources.

An alternative mode of enforcement is through reputation. The idea is that consumers, rather than relying on the state, will trace producers' past performance and translate it into expected quality. Yet for reputation to be able to fulfill this disciplining role, a high degree of information flow, or transparency, is imperative. Transparency, of course, is not something that transition economies typically excel in.

In this article we discuss a third form of enforcement that relies much less, or not at all, on the state, and that relies on the market only indirectly: Certification agencies force their members to reveal their (good) type through costly signals that can be "engineered" to induce a separating equilibrium. We discuss the viability of this system of enforcement in an environment where state and market have failed to deliver a satisfying degree of quality assurance (namely, fundraising), and also discuss related information systems and systems of quality assurance.

1. Introduction

Where there is a problem, one often finds the belief that a law or regulation can, and ought to, take care of it (Muris, 2002; Roland and Verdier, 2003). Even under the best of circumstances, however, this is a dubious belief. Third-party enforcement through the state is expensive and tends to be ineffective especially when the quality of goods and services is observable but not, or not easily, verifiable in court (Akerlof, 1970; Tirole, 1988). Every student, for example, knows when a professor takes his responsibilities lightly. Typically, however, a student will not be able to enforce good teaching, or dissertation supervision, in court. Things get worse when the quality of goods and services is not even observable, or only at prohibitively high cost (Darby and Karni, 1973). How, for example, would one go about proving in court that one's donation to a nonprofit (e.g., for the recent tsunami disaster relief efforts, or for flood victims in the Czech Republic) was not used the way it was intended? Below, following the economics literature, we sometimes call such services credence goods.

Drawing on the notion that consumers often have choices, and can vote with their feet if they are displeased with a good or service, economists since Adam Smith have made the case for reputation as an effective disciplining device in many of the situations where third-party enforcement fails, or works poorly (e.g., Heal, 1976; Klein and Leffler, 1981; Ortmann 1999, 2001). Unfortunately, reputational enforcement has its drawbacks too: it can only work if supported by fairly strong information flows (Tullock, 1985; Frank, 1988, especially chapter 3). So while it may be easy to ascertain, even for individual consumers, the reputation of local taxi enterprises (e.g., AAA), it is much more difficult to ascertain the quality of firms that provide educational, health, or other (social) services such as disaster relief efforts. There are many such situations of asymmetric information where quality assurance through third-party enforcement or reputation is all but impossible. What, then, can be done?

We propose that properly designed systems of certification have tremendous potential especially in situations where both the state and the market are likely to fail in their enforcement function. Throughout we use donative nonprofits (nonprofits which finance

themselves significantly out of donations and hence have to raise, either on their own or by way of some fundraising firms, funds from public or state entities) as a running example. We call the problem of asymmetric information in the context of donative nonprofits the *fundraising problem*. This problem is closely related to the problem of whether charities manage their funds wisely and efficiently, a problem occasionally called the credibility problem (e.g., Gibelman and Gelman 2004) for reasons we will have to say more about below. Since the credibility problem is closely related to the fundraising problem (e.g., Ortmann and Schlesinger 2003), below we often talk, somewhat simplifying, about the fundraising problem.² We note that most of our arguments apply also to commercial nonprofits (nonprofits which finance themselves for the most part from selling their products to everyone willing to pay for them) and, more generally, even to for-profits that provide experience or credence goods.

We choose donative nonprofits as our running example because this manuscript is meant to inform the discussion about a certification system for donative nonprofits in the Czech Republic that will draw on the experiences of similar initiatives in Europe, Canada, and the U.S.A. Theoretical reflection seems warranted since the extant systems display remarkable diversity. This diversity is, maybe, not all that surprising given that these systems evolved at different times and in different places, and that an optimal system for all these circumstances is unlikely to exist. Of particular importance is that none of the extant systems has evolved in a transition economy, for reasons that we can only speculate about.³ There are also prominent examples of such projects that faltered over the last few years. Given that significant sums are involved in the design and implementation of certification systems, theoretical reflection about the promises and pitfalls of such systems seems very much in order.

² Roughly speaking, the credibility problem is concerned with nonprofits doing what they say they will, and whether they do so wisely and efficiently. All nonprofits face this problem, whether they raise funds or not. In a sense, the credibility problem addresses the issue of whether indeed nonprofits deliver the quid-pro-quo that is implied by the tax and regulatory breaks bestowed upon all nonprofits. The fundraising problem identifies the credibility problem with respect to a specific, and arguably particularly important revenue source that – because of its atomistic composition – tends to be most severely exposed to the asymmetric information problem.

³ It is our reading that throughout the nineties consumer protection was not a high priority. This may have been a response to more pressing demands on scarce enforcement resources, lack of effective consumer protection laws, and the fact that there was no strong demand for high quality and services to start with.

The remainder of the paper is structured as follows: In section 2 we describe U.S. attempts to solve the fundraising problem as well as some European success stories of certification solutions to the fundraising problem. We also pay attention to a failed attempt at such a solution – “we learn from failure, not from success!” (Stoker, 1897) after all – before summarizing other extant quality assurance systems. In section 3 we sketch out the stylized facts, or commonalities, that emerge from our review. In section 4 we examine what economic theory has to say about the stylized facts that we identified and about the fundraising problem, and where the extant theory is deficient. Section 5 concludes with a list of design and implementation issues.

2. The Fundraising Problem: Some (attempted) solutions

The nonprofit sector (also called the third sector, or civil sector) finances itself partially out of donations which, unlike funds from state agencies, are contributions from citizens and grant-making agencies that may or may not be dedicated to a specific purpose. According to Salamon et al. (1999) donations accounted in 1995 on average for less than 10 % of nonprofit revenues in Western countries. The percentage is more than twice as high in areas such as environmental protection, culture, or various forms of international help. While these percentages may appear relatively insignificant, the absolute numbers are not: giving in the U.S.A., for example, amounted to \$240 billion in 2003 (Giving USA, 2004). Donations sometimes come unsolicited (such as when Bill Gates gives away some of his wealth for purposes close to his heart) but typically donations are solicited through fundraising activities of the nonprofits themselves, or organizations that specialize in fundraising.

Fundraising brings up a number of interesting issues. For example, do those competing for funds honor truth in advertising, or do they dramatize their mission to increase the willingness of potential donors to give? What is an appropriate fundraising ratio anyway? That is, how much should it cost to raise a dollar or euro to fund some project that benefits the public? One percent? Ten percent? Twenty-five? Fifty?

And once funds have been raised, are they indeed spent for the purpose for which they were raised? This question addresses the wide-spread perception among donors that nonprofits, whether donative or commercial, are rather incompetent at spending money wisely and efficiently (e.g., Bradley, Jansen, and Silverman 2003; Light 2004, 2004a; Gibelman and Gelman 2004).

A prominent case that highlighted the fundraising problem was the Red Cross's Liberty Fund, set up as a special account to aid the victims of the September 11 attacks on the World Trade Center and the Pentagon. The Red Cross tried to divert some of these funds to upgrade its telecommunications system and to build up its blood reserves. While these activities may have been sensible things to do, they were not what donors had in mind when they poured almost 1 billion dollar money into the fund.⁴

Another case illustrative of these issues, albeit from a different perspective, was the decision of various branches of Medecins Sans Frontiers (MSF) to ask the public, less than 10 days after the disaster hit, not to send any more money for its tsunami relief efforts. The organization felt that it had collected enough money to finance the emergency aid mission in which it specializes. Curiously, the organization was criticized by numerous other organizations for this announcement; apparently some of these critics suggested that MSF should have done what the Red Cross did and was taken to task for. Less prominent but more pervasive (and harder to detect) are various forms of gift exchange, internal cross-subsidization, or mission drift (e.g., Ortmann & Squire 2000).

Two curious facts suggest that these, or similar problems ("tunneling"), also afflict the nonprofit sector in the Czech Republic. Of the organizations comprising the Czech nonprofit sector, 88% are associations with no legal requirements mandating their

⁴ Light (2004 a, p. 1) argues that "the controversies surrounding the disbursement of the September 11 relief funds and subsequent nationally-visible scandals surrounding the Nature Conservancy and several private foundations appear to have left a durable imprint that has yet to fade." Light (2004) backs up this statement with numerous survey data.

accountability or disclosure of information.⁵ More closely followed organizations such as foundations and foundation funds comprise only 2%, and public benefit organizations only 1.5% of the sector (Brhlikova, 2004). Nevertheless, even the disclosure of legally required information is lacking: in 2002, for example, only 32.9 % of foundations and foundation funds supplied their annual reports to their respective courts as required by law (CVNS, 2004), a dismal record that is bound to induce lack of accountability and transparency.

Examples like the Red Cross's Liberty Fund, or the apparent lack of understanding of the importance of accountability and transparency displayed by the reporting behavior of Czech foundations or foundation funds, are likely to generate negative reputational spillover effects which can affect dramatically the trustworthiness, and ultimately viability, of the third sector as a whole (Ortmann and Schlesinger, 2003; Gibelman and Gelman, 2004; Light, 2004, 2004a; Panel on the Nonprofit Sector, 2005; Senate Finance Committee staff, 2004⁶). What can be done? And what has been done elsewhere?

2.a. The U.S. solution(s)

2.a.1. IRS form 990, GuideStar, and related services

Not surprisingly, given the prominent and relatively long-lasting role the third sector has played there, the U.S.A. has dealt with the fundraising problem, and related problems of misrepresentation and fraud, for decades (e.g., Ortmann and Schlesinger, 2003, pp. 82 – 85; see also Stamler, 2004 a, b) Initially, guided by a belief in the efficacy of laws and regulations, the U.S.A. tried to solve this problem using third-party enforcement. Specifically, the Internal Revenue Service (IRS), in conjunction with the General

⁵ The number may be an overestimate, as the associations do not provide information about their termination. It is therefore not possible to obtain an exact number of working organizations.

⁶ In response to the controversies surrounding the disbursement of the September 11 relief funds, etc., the Finance Committee of the Senate of the U.S.A. issued in the summer of 2004 a white paper on various changes it might consider as a means to reduce abuse and fraud in the nonprofit sector; it also invited the Independent Sector (www.independentsector.org) to comment on that draft. The Independent Sector, jolted into action by the white paper, then convened the Panel on the Nonprofit Sector (www.nonprofitpanel.org)

Attorney offices of the states, was charged with enforcing the non-distribution and reasonable compensation constraints, together with other regulations pertaining to nonprofits.

A typical nonprofit organization in the U.S.A. with revenues above \$25,000 is legally required to fill out IRS Form 990 which requires nonprofits to divulge – and to divulge to the members of the public – information such as revenues, assets and expenditures for program activities, administration and fundraising, as well as information on board members, directors, and key employees, including their salaries.⁷

Several shortcomings of this solution have been identified over time: In the past the returned forms were essentially stored away in some drawer – rarely to see the light again – because the IRS simply did not have the resources to check even a small fraction of the forms received. This fact, in turn, reduced nonprofits' incentive to report properly (Froelich, Knoepfle, and Pollak, 2000, pp. 245 – 6; Senate Finance Committee staff, 2004, pp. 8 – 9, pp. 18 - 19). But even those who do fill out the form have been critical of the guidance provided, especially if they are professionally trained (Froelich, et al. 2000, pp. 245; Senate Finance Committee staff, 2004, pp. 8 - 9).

In an attempt to improve the accountability and transparency of the nonprofit sector, new legislation and its interpretations in 1999 required most organizations in the sector to make their Form 990 easily accessible. Internet-based services such as GuideStar (www.guidestar.org), the National Center for Charitable Statistics (nccsdataweb.urban.org), or the cyber-accountability network (www.cyb-acc.org), have used those opportunities to provide guidance on how to fill out Form 990, to change nonprofits' incentives to report properly, and to persuade charitable and nonprofit organizations that completing Form 990 correctly and carefully might in fact be a strategy that is likely to have significant payoffs (e.g. www.crcmn.org/npresources/truthtips.pdf).

in a clear attempt to influence the outcome of the Finance Committee's deliberations. Nunez (2001) suggests in which direction this influence is likely to go; more on the issue of self-regulation below.

⁷ The minimum revenue cut-off point means that about 70% of nonprofits do not have to fill out Form 990.

GuideStar in particular is a tremendous success story by some measures. For one it has become *the* public disclosure vehicle of IRS data. Founded in 1994, it currently maintains database records for more than one million U.S. organizations and has extracted from the annual filings with the IRS extensive financial and descriptive records time series for the 300,000 largest nonprofits. Yet GuideStar is much more than a derivative of IRS Form 990: It supplements these data with voluntary answers to its own questionnaire which is currently filled out by about 10 percent of nonprofits. This number, however, is misleading⁸, as the participants comprise more than 20 percent of the filing charities (which account for 99 percent of all charitable activity), and because participation is skewed toward larger, fundraising-type charities, roughly 50 percent of the economic and fundraising activity of all U.S. charities.

GuideStar's basic services are free to everyone that registers; at present it has more than 250,000 registered users of which the majority is nonprofits. Additional GuideStar PLUS information services such as "Analyst Reports" (each report includes peer group comparisons) or "Compensation Reports" are available for a fee. The company (a nonprofit whose own Form 990 is available on the GuideStar site) currently has a budget of \$6 million, one third of which is covered by fees for services and two thirds by donations. The company's goal is to finance about 70 – 80% of its costs through its GuideStar PLUS services within a couple of years. It recently launched www.guidestar.uk.org, a similarly constructed charity information website in the United Kingdom whose first three years of existence has been funded by the Treasury through a grant of almost \$5 million. A pilot project in South Africa is well on its way, as is an exploration project in Germany. These various initiatives are coordinated by GuideStar International which was formed in October 2004 and is conceptualized as a collaborative effort in "sharing technology, data, best practices, and international fund-raising" (www.guidestar.org/about/press/041004_gs_intl.jsp)

⁸ We thank Buzz Schmidt, chairman emeritus of GuideStar, and now chairman of GuideStar International, for setting us straight.

It will be interesting to follow these developments closely, for at least two reasons. In the United Kingdom, information similar to that obtained from the 990 Form seems readily available; but in South Africa, Germany and the Czech Republic the equivalent of a 990 Form does not exist, or at least is not publicly available. Plus, it is not clear whether the tremendous funds that GuideStar has been able to attract in the U.S. and the U.K. will be forthcoming elsewhere. In short, the economic viability of the project has yet to be proven. It may have to rely to a significant extent on private and public donations well beyond the take-off phase.

There can be little doubt that the GuideStar model does bring significant benefits to its various stakeholders that might justify such donations, even in a steady state equilibrium. It is a tremendous source of information for donors, grant makers, government regulators, policy makers, and various professionals (including academic researchers, who interestingly account for only a rather small slice of the currently 5 million annual visits to the GuideStar website in the U.S.A.). It is also a tremendous source of information for not-for-profits who want to compare themselves to their competitors (e.g., through the peer group comparison service).

By ratcheting up the scope of the questionnaire GuideStar could, and apparently intends to (although we have heard differing opinions on this issue), increasingly take on characteristics of a certification agency.⁹ Indeed, to the extent that GuideStar will not be able to work in countries such as South Africa, Germany, and the Czech Republic with a ready-made set of data similar to those provided by IRS Form 990, it will have to devise a system of voluntary submission of data. It will be interesting to see what kind of system of carrots and sticks will be devised. It will also be interesting to see how GuideStar-like systems such as the Dutch “donateursvereniging” (www.geefwijzer.nl) will solve the same problem, and how these systems will affect certification agencies, to be discussed presently.

⁹ It would be interesting to assess empirically how those that supplied additional information to GuideStar have fared in terms of their revenues relative to those that did not. Our conjecture is that so far it has not made a difference because the additional questions are too vague and can be answered falsely with impunity.

In our view, the key problem with the GuideStar model is its exclusive reliance on information provided by the organizations themselves, leaving significant leeway for those that try to bend the rules. Mission drift, for example, cannot be captured in any reasonable manner by way of GuideStar data, nor can untruthfulness in communication, use of restricted funds for operational purposes, inadequate documentation or misuse of expense reporting, improper allocation of fundraising and overhead expenses, or similar recurring compliance issues. While GuideStar, and the many initiatives it has spawned, is likely to lead to increased transparency and accountability of the sector through increased accessibility and quality of the information reported in Form 990, it is for the time being unlikely to allow consumers to really sort out the good guys from the bad guys (even if the consumer is savvy enough to read the “Analyst Reports” that GuideStar provides and that are probably one’s best bet to identify truly deviant behavior). So, what does allow for this?

2.a.2. “Standards for Excellence” and related certification systems

Concerns about the efficacy of IRS enforcement motivated the Maryland Association for Nonprofit Organizations (www.marylandnonprofits.org, from here on Maryland Nonprofits) to launch in 1997 a certification program that checks the quality of nonprofits in the state against Standards for Excellence.¹⁰ If the organization passes the certification check it is awarded the Standards for Excellence seal (www.standardsforexcellenceinstitute.org). In light of the fact that the program is now in the process of being implemented in other states¹¹, the program is considered a success in high places (e.g. Senate Finance Committee, 2004, p. 18), despite a relatively low and

¹⁰ The Standards of Excellence consist of guiding principles, or core values, such as honesty, integrity, fairness, respect, trust, compassion, and responsibility that are applied to eight areas of concern (Mission and Program, Governing Body, Conflict of Interest, Human Resources, Financial and Legal, Openness, Fundraising, Public Affairs and Public Policy) and that are further developed in 55 specific standards.

¹¹ After several organizations from other states showed their interest in replicating the Maryland Standards for Excellence program in their areas, Maryland Nonprofits established an umbrella organization, Standards for Excellence Institute, whose job it is to sell the program to other states and to coordinate the various efforts. As of January 2005, the program operates in 7 states – some already administering certification, others only offering training and consulting services – but it is expected be launched in 30 more states in the near future.

slowly increasing participation rate of organizations in Maryland: As of January 2005, only 53 organizations out of more than 1400 potential candidates (i.e. members of Maryland Nonprofits) had the seal.¹²

It is of particular interest in the present context that Maryland Nonprofits and its associate organizations does not restrict its program in other than a geographical manner, i.e. all organizations that are recognized as nonprofit by the IRS and reside in the corresponding state can, in principle, be certified. This prevents the certifier from imposing standards that would be too ‘industry’ specific. As we will see, other certification agencies – in particular those in Europe, to be discussed below – have chosen a different model.

Another distinguishing characteristic of Maryland Nonprofits is its goal to offer “a full range of services designed to help all nonprofits more effectively serve the community.” The idea is to fix through consulting and training sessions what might be broken. The certificate therefore resembles more a diploma for passing the required consulting and training units. Clearly, this produces a situation where conflicts of interest are likely to happen.

Yet another distinguishing characteristic is the fact that on-site meetings may occur as part of the review process but don’t have too, giving the investigative process considerably less depth and thus decreasing the probability that organizations which misrepresent their true nature are detected.

Another organization that has recently started certification in the U.S.A. is the Better Business Bureau’s (BBB) Wise Giving Alliance, an organization that resulted from the 2001 merger of 2 nonprofits (the National Charities Information Bureau, the Council of Better Business Bureaus Foundation, and its Philanthropic Advisory Service); it is affiliated with the Council of Better Business Bureaus. Its main purpose until recently

¹² As of February 2005 GuideStar counts 1993 participants out of 25,125 (990-filing and non-filing) Maryland charities in its database that provide additional information. Recall though that the information is not independently verified and, in any case, is a fraction of what certification agencies (to be discussed in more detail below) typically ask for.

was the provision of information on organizations that solicit nationally or have national programs. In early 2003, the BBB Wise Giving Alliance launched a certification program which differs from that of the Maryland Association of Nonprofit Organizations in that it focuses on national charities only. Another important difference is that the fee organizations have to pay is not charged for the evaluation but for the possibility to use the seal. All organizations are evaluated in the same manner (and for free), but only those that pay the fee are awarded the seal and can use it on their website and publications. As of January 2005, 51 organizations have the seal.

Notably, the ECFA (Evangelical Council for Financial Accountability, www.ecfa.org), is a Christian organization that has provided certification for 25 years and currently has more than 1100 members (nonprofits); the certificate being membership in the organization. Membership requires signing the Statement of Faith, i.e. the organizations must be evangelical, which alone significantly restricts potential membership. The other requirements are summarized in 6 points concerning the management, financial management, disclosure and fundraising practices (the fundraising practices are further developed in 11 points). The standards are formulated in a rather broad manner, although each standard is provided with an extensive commentary, including practical guidelines. ECFA performs on-site checks of approximately 10 percent of its members each year; it receives no subsidies, and 100 percent of its costs are covered by membership fees. The requirement for eligibility is similar to that for Maryland Nonprofits – the restriction being not geographical but ideological. No other restriction applies – any type of nonprofit organization may apply. In the way it is organized, however, ECFA resembles the way European certification agencies such as CBF, DZI, or ZEWO operate (about which more below).¹³

It is curious why there were no earlier attempts in the U.S.A. to start secular certification programs. Most likely it is the result of the belief, widespread until fairly recently, that

¹³ Wilke (2005), available in draft only after a second draft of our paper had been circulating, has an extensive and very useful discussion of the three organizations reviewed in this section; it is unfortunately written in German.

issues of accountability and transparency are to be solved by the state.¹⁴ Form 990 and organizations using that form as their major input (at least for now) clearly are such attempts but, as we have seen, they do have their problems. The recent emergence of Maryland Nonprofits and the BBB Wise Giving Alliance certification programs, as well as the earlier emergence of ECFA, strikes us an indicator of these problems. Given their relatively recent emergence and state of flux, or peculiar market niche, it seems too early to draw conclusions about these models' viability.

2.b. Seemingly successful European solutions: Examples from Germany, the Netherlands, Switzerland, and Austria

Contrary to the U.S., third sector certification systems have a long tradition in several European countries (e.g. Switzerland, about 70 years, Norway and Sweden, about 60 years, France, 15 years, Germany and the Netherlands, about 10 years). Guet (2002), in close cooperation with the International Committee of Fundraising Organizations (ICFO), has described eight such systems within Europe (and two Christian monitoring agencies in the U.S.A. – the already briefly discussed ECFA – and Canada). Due to space constraints we focus below on the certification agencies in the Netherlands, Germany, Switzerland, Austria (all this section), and England (in the next).¹⁵ In contrast to Maryland Nonprofits, most of these systems focus on fundraising organizations that work on the national level. While there are many differences in the scope and mode of operation and funding of the certification agencies reviewed in Guet (2002) and below – something not really surprising given the evolutionary trial-and-error ways in which they

¹⁴ Commenting on the preceding statement, Wilke (2005) suggests an alternative explanation: that the high degree of organization of nonprofits (in networks such as Independent Sector etc.), and their lobbies, tend to favor stricter attempts at self-regulation over independent certification in times of crisis. This is a persuasive argument: one just has to look at the composition of the Panel on Nonprofit Sector that currently tries to address the concerns of the Senate Finance Committee to see that there must be some truth to that proposition.

¹⁵ Our discussion draws on Bekkers (2003), Guet (2002), information generously supplied the organizations that we discuss, as well as lengthy interviews two of the present authors (AO, AK) had with the chief executive officers of the Central Bureau of Fundraising (CBF) in Amsterdam and the Deutsche Zentralinstitut fuer Soziale Fragen (DZI) in Berlin, a long telephone conversation that AO had with the chief executive of ZEWO, numerous conversations that two of the present authors (AO, KS) had at the ICFO meeting in Vienna in May 2004, and generous comments by Bekkers and Wilke on earlier versions of this manuscript.

have grown, and the different fiscal and legal environments in which they operate – two polar models emerge. One is the model pursued by the Dutch and German certification agencies, Central Bureau Fondsenwerving (CBF) and Deutsches Zentralinstitut fuer soziale Fragen (DZI), respectively. The other model is pursued by the Austrian certification agency. The Swiss model is a hybrid of sorts of these two polar models, albeit arguably closer to the Dutch-German model. At first glance, the organizational difference between the Dutch and German model on the one hand and the Austrian on the other is the decision to conduct the detailed evaluation of participant organizations in-house (the former) or to have it done by outside examiners (“Wirtschaftspruefer”, the latter).

While CBF and DZI started their certification activities in 1995 and 1992, respectively, DZI was established in 1893 (focusing initially on the documentation and critical commentary of social work in general and of charity activities in particular) and CBF was established in 1925 (focusing initially on coordination at the local level of the fundraising activities of national charities). The Swiss certification system (ZEWO) started certification in 1940, having been established in 1934. Interestingly, until 2001 ZEWO was more akin to a self-regulatory collective. The credibility problem that that organizational form brought about – to be discussed more generally below in section 3 – led to a radical reorganization that was, initially, probably too much oriented toward consumer protection. The current organizational form gives the target organizations significant input in the process of determining the standards but restricts their involvement in the evaluation process proper.

All three certification agencies have reached a general level of acceptance (about 30 percent name recognition in the total population, with the percentage being higher in that part of the population that indeed gives), and with the reputation of the ZEWO seal so strong that “some cantons do only allow/approve collections by organizations which have the ZEWO seal of approval; other cantons do ask the opinion of ZEWO before allowing a collection.” (Guet, 2002, p. 27). Along similar lines, in Germany the Federal Ministry on

Economic Cooperation and Development and the Foreign Office have simplified their application procedures for those charities which have been awarded the DZI seal of approval (Wilke, 2003).

CBF and DZI focus on national and supra-regional fundraising institutions, respectively. Until recently, DZI restricted its certification activities to those organizations pursuing humanitarian and social goals; since January 2004 it has started to certify all exempt public benefit organizations (political parties excluded). CBF covers very much the same ground. Both organizations presently have awarded their seal of approval to about 200 organizations. In contrast, ZEWO currently has awarded its seal of approval to about 475 foundations and public benefit associations, reflecting possibly its longer history.

All three organizations provide various degrees information about entities that have not been certified (yet). All three organizations approve the seal for a fixed period of time (DZI, yearly; CBF and ZEWO, every 5 years), with an intense initial screening process at the beginning. Interestingly, and importantly, although an audited financial statement is required, all three certification agencies require more information than just the financial statements. These additional information requests seem to have two functions: revelation of the additional information per se (which also allows cross-checking for the plausibility of other information) as well as the applicant's willingness to divulge those bits of information. If a charity is less than forthcoming with the required information, it is taken as a signal of its lack of trustworthiness. In other words, the certification agencies believe that it is their job to assess trustworthiness but not to induce it, "feststellen, nicht herstellen" as the DZI CEO put it. This strategy is, for good reasons that we shall argue below, in marked contrast to that of the Maryland Nonprofits approach. All organizations require accuracy of information, honest fundraising practices (truth in advertising!), and a prohibition against pressure being exerted on potential donors.

All three institutions charge for the certification process. Pricing varies. While ZEWO, CBF, and DZI charge for every evaluation, the fee depends on the costs of the evaluation

or on the volume of fundraising income. For example, the initial fees charged by DZI and CBF are currently 1,500 € and 3,630 € respectively; subsequent evaluations (each year) are 500-7,000 € and 250-5,000 €, respectively, depending on the size of the organization that is evaluated. The ZEWO initial fee is 2,260 – 4,500 €, annual fees are 320-7,000 € (with the average being about 600 €), and the re-certification fee (every 5 years) amounts to 1,200-2,260 €. The annual fees are computed as 25 per mill of revenues. The low average reflects the skewed distribution of organization size with few firms being large and many being small. It is important to understand that these out-of-pocket expenses are, however, only part of the total costs of acquiring, and maintaining, the seal of approval. Since the questionnaires that have to be filled out go significantly beyond what audited financial statements require, there is a substantial cost connected to the provision of that information. Exactly what these costs are, we have not been able to discern; they seem to vary widely (from less than a week to several weeks of manpower).

Interestingly, CBF (about 40 percent) and DZI (about 30 percent) are not fully financed from fees paid by the monitored charities.¹⁶ In contrast, all other certification agencies discussed in Guet (2002) are (almost) completely self-financed from fees paid by the monitored institutions or from contributions. This is also the case for ZEWO, which finances about 99% of its operations from fees. That said, as we will see below when discussing the Austrian case, the depth of investigation and therefore the detection probability of “bad apples” differs dramatically across CBF and DZI on the one hand and other organizations on the other: The depth of investigation is a, if not *the*, key cost-component of the certification activities, and any assessment of a certification procedure has to trade off these costs with the welfare benefits of an increased detection probability. In addition, less than complete reliance on fees is, in the view of the ZEWO CEO, likely to increase an agency’s independence. It would, for example, make it easier to have re-certification every three years rather than every five years.

¹⁶ To be more precise: For 2005, DZI has a budget of 1.050,000 € from which about 430,000 € is its own income in the form of certification fees (300,000 €), library/publishing (95,000 €), etc. DZI’s donor advice and seal-of-approval departments (roughly comparable to CBF as a whole) has a budget of 670,000 €, with 330,000 € its own income and 340,000 € subsidies from the federal government.

The three organizations just reviewed pursue, to varying degrees, other activities. DZI, for example, understands itself also as a depository of information about issues involving social work, broadly constructed. Following its original mission, it answers bibliographic queries and also produces a journal. Importantly, it also keeps track of a significant number of organizations that are candidates for the seal but that have either not applied or have been turned down. In effect, DZI answers per year about 300 – 400 press queries, many of which are not concerned with those companies that do have the seal of approval. In the wake of the tsunami relief efforts, it handled more than 200 queries. Both CFB and ZEWO also, albeit to a lesser degree, engage in information and publishing activities. Both, for example, publish an annual almanac that features those charities that were awarded the seal of approval.

DZI (about 20 full-time equivalent employees, of which about 13 work for the donor advice and seal-of-approval departments) and CBF (about 15 full-time equivalent employees) are of about equal size, with ZEWO currently having about 5 full-time equivalent employees but planning to enlarge in the near future. The smaller number of employees at ZEWO is a function of the way the evaluation is organized. Like the Austrian certification agency to be discussed presently, ZEWO relies heavily (albeit not as extremely) on external examiners. The number of full-time employees is a bit misleading because of the different tasks that the certification agencies undertake. The certification branch of DZI, for example, consists of five what could be called “field investigators” and three assistants, with the CEO and his deputy signing off on every report. Of course, support and administrative staff do also work for the donor advice and certification process, summing to about two-thirds of DZI’s manpower.

The Austrian model differs radically from that of its Dutch and German counterparts. Specifically, the Austrian Institute for Fundraising (Österreichische Institut für Spendenwesen – ÖIS; founded in 1996) defines as its major function, similar to DZI, provision of information about the sector. The ÖIS is a division of the Austrian Foundation for Development Aid Research (Österreichische Forschungsförderung für Entwicklungshilfe). Interestingly, although the ÖIS was involved in the development of

the standards for the seal of approval, the seal of approval itself (awarded since November 2001) is administered by the Chamber of Accountants (Kammer der Wirtschaftstreuhänder).¹⁷ In effect, the whole certification operation at the Kammer exists of one person who spends, supported by a secretary, part of her/his time on coordinating the activities connected with this job. How does s/he do it? By reliance on external accountants that are paid in full by the applicants.

The obvious advantage of this solution is the ability to rather quickly expand the number of certified firms. In the Austrian case, this means that almost 50 firms were certified during 2001, while during 2002 almost 100 firms¹⁸ (including most of the initial almost 50) made the grade – out of 600 organizations that qualify in principle.

The obvious disadvantage of the Austrian solution is the problem of quality assurance and comparability of the interpretation of the standards. The standards by their very nature are, to quite an extent, “soft” and open to subjective interpretation. As the reliance on external accountants increases, the standards are more likely to be interpreted less uniformly. Plus, a few in-house accountants who investigate a couple hundred organizations on a regular basis are more likely to develop a “feel” for compliance issues, since they will have more similar organizations to investigate than their counterparts under the Austrian scheme who are likely to investigate only a handful, and quite possibly, rather diverse organizations. Lastly, the incentives of external accountants may be very different from those of in-house accountants.

The theoretical problem is to what extent the Austrian solution might increase the probability of the certification procedure becoming a less effective separating device of good and bad types, and to what extent therefore the probability of a bad type leading to

¹⁷ It is our understanding that this was the result of a compromise of sorts. The Austrian Foundation for Development Aid Research was originally interested in building a DZI-like organization but could not get support from partners that later signed a three-year cooperation agreement that was then implemented by the Kammer of Wirtschaftstreuhänder (“accountants”).

¹⁸ Interestingly, and maybe not surprisingly, these firms command about 25 percent of the funds that are raised by the 500 organizations that are not yet certified. To what extent this reflects some sort of selection bias, or to what extent it reflects already a payoff of the increased trustworthiness that the seal of approval bestows is an open question an answer to which would be highly desirable.

reputational spillover effects might increase. The devil is clearly in the details here but the trade-off seems to warrant more investigation. On the basis of its relatively short track record, the Austrian model seems viable but it is, perhaps, too early to issue a final verdict.¹⁹ Hence the title of this section.

2.c. Some failures worth keeping in mind: Examples from Europe

While there are a number of success stories such as CBF, DZI, and ZEWO, there are also a couple of interesting failures: projects that have not managed to become serious competitors to existing institutions. We concentrate here on two, one in Germany and one in England.

The English case is remarkable for a variety of reasons. The Accrediting Bureau for Fundraising Organizations (ABFO), an initiative supported by the well-known and well-established Consumers' Association, developed standards for organizations that raise funds from the public for charitable and public interest purposes in early 1996, and in late 1996 arranged a series of trials with five volunteer fundraising bodies to validate the application of the standards. An internal report in January 1997 called these trials "successful in meeting the objectives" and standards were found to be effective in examining the workings of the organizations visited. The trial organizations themselves were reported as seeing accreditation as "a useful, positive 'health check'". The trial organizations also saw considerable advantages in going through some such health check.

Yet almost three years later, only two organizations had been accredited and in what looked like an act of desperation, ABFO considered accreditation of the Royal National Lifeboat Institute, possibly against its will (although the wisdom of such a confrontational approach to the sector was doubted by some). In an internal memo in March 2000, ABFO's meager progress was attributed to two main obstacles: "the basic resistance of the entire charity sector to external scrutiny" and "the lack of an effective

¹⁹ Here, too, it would be desirable to have hard facts about the impact that the seal of approval had on the revenue generation of those that were awarded the seal of approval.

lobby, which believes fervently that charities *should* be susceptible to scrutiny, and in particular that fund-raising charities *should* be accredited.”

That effective body could, and probably should have been, the Charity Commission (which, interestingly, now seems to accept the GuideStar U.K. initiative, and which seems to have been pushed into reforming itself through this new threat; see the April 1 2004 announcement of its own online database launch of charity accounts and governing documents). The Charity Commission, however, never adopted the concept of a certification scheme. And the support of the Consumers’ Association ultimately did not carry ABFO through; it essentially went into a state of hibernation in 2002 without ever realizing ideas that were fairly close to those that GuideStar U.K. has been implementing thanks to a huge grant by HM Treasury Invest to Save Budget (www.guidestar.uk.org/support.htm).

From a distance it is, of course, difficult to assess what actually led to the non-acceptance of a proposition that in other countries thrived. The evidence that we have seen and discussed suggests strongly that the failure to bring key players from the sector on board, for whatever reason it was, seems to have been the kiss of death (at least for now) of the English patient.

In Germany, DZI has over the years experienced various competitors, the most prominent ones being the Deutsche Spendeninstitut Krefeld and the Deutsche Spendenrat. The Deutsche Spendeninstitut Krefeld modeled itself to some extent after GuideStar but, after 6 years of existence, had to shut down when it was not able to secure the donations or state funding necessary to finance its continued existence. A major part of the problem seems to have been the lack of the kind of information that is publicly available in the U.S.A. and U.K. Another problem seems to have been the questionable transparency of the whole enterprise, including its profit- and software-making divisions.

The fact that of all the countries discussed in Guet (2002) one, and only one, certification agency has managed to establish itself, is an interesting fact that suggests at first glance

that there may be economies of scale (and scope) to be captured. Here, too, it seems too early to hand down a final verdict. More empirical research seems in order.

2.d. Related systems of quality assurance

The problem of quality assurance is one that does not just pertain to the fundraising problem, or to nonprofits. In essence, every industry that produces experience or credence goods faces the resultant asymmetric information problem, as Adam Smith observed astutely (Ortmann, 1999). Not surprisingly then, we do find other quality assurance systems which we shall therefore briefly discuss.²⁰

2.d.1. ISO 9000, ISO 14000

ISO stands for the International Organization for Standardization. ISO has developed several sets of standards, the best-known being the ISO 9000 system and the ISO 14000 system. ISO 9000 is a set of standards for management of quality, while ISO 14000 guides the management of environmental issues. Because the basic modus operandi is similar, we focus on the ISO 9000.

The so-called ISO 9000 family consists of a number of standards guiding quality management. ISO 9001 is the only member of the family to issue a standard “against which a third party certification can be carried” (www.isoeasy.org), i.e. a seal of approval can be issued. It applies to manufacturing as well as to service industries. ISO itself neither issues, nor approves, certificates; the organization only develops the standards. Certificates are issued by certification agencies existing throughout the world. Some countries, such as the Czech Republic, require that these certification agencies be

²⁰ Wilke (2005) points out that the RAL Institute (www.ral.de) in Germany started, because of the large number of seal-of-approval systems, a certification system for certifiers. As of the end of year 2004, 172 certifiers were themselves RAL-certified. Wilke (2005) also discusses a study prepared by the Institut fuer Ökologische Wirtschaftsforschung that lists three criteria that a seal-of-approval system ought to fulfill to have credibility: the independence of the issuing agency from applicants, the objectivity of the criteria/the degree to which the criteria go beyond legal or regulatory requirements, and the transparent development of the criteria/the thoroughness with which the evaluations are conducted. According to Wilke, world-wide only about 20 certification systems for charities fulfill these criteria.

accredited by a national accreditation body (which in the Czech Republic is a nonprofit organization).

The general aim of ISO 9001 standards is to assure product quality ('product' being used as a generic term for both goods and services). The purpose of product quality is customer satisfaction and compliance with applicable regulations. The system attempts to achieve these goals by controlling the whole process of production in the company, under the assumption that quality production will lead to quality products. Strictly speaking, ISO certification thus guarantees processes aimed at customer satisfaction rather than products, but this distinction is academic in that a poor product invariably identifies problems with the process that produced it.

The process of ISO 9001 certification is more complicated than the processes described in section 2.b. This is partially due to the fact that obtaining the certificate usually requires significant changes in the operation of the company as well as the introduction of new policies, while the certification of nonprofits mostly assesses the current situation. The typical ISO certification process consists of the following: demand/inquiry, informative interview, written application/filling out of questionnaires, examination of the application, approval of the application, contract, establishment of an auditing committee, pre-certification audit, result and corrections if applicable, certification audit, result and corrections if applicable, certificate proposal, issue of certificate, audits. The seal is valid for 3 years; audits are carried out regularly depending on the certifying company, but usually occur twice a year. The costs of ISO certification seem to be (significantly) higher than those incurred by certification of CBF, DZI, and ZEWO, for example, though we have not been able to ascertain the costs more precisely.

Importantly, over the past couple of years there have been instances of NPOs acquiring the ISO certification, namely the Business Education Council of Niagara, Canada (Moffatt, 2002) and Medair, an international humanitarian aid organization with headquarters in Switzerland (Verboom, 2002). The case of Medair is particularly interesting here since Medair is certified by both the ISO 9001 and ZEWO. Clearly, at

least the decision makers at Medair must have thought that there is value added in both certificates. It would be desirable to understand the relative advantages of these two systems better.

2.d.2. Accreditation of institutions providing higher education in the U.S.A.

While most nations control the quality of education through governmental agencies, in the U.S.A. the monitoring has traditionally been performed by private, nonprofit institutions: At least since 1952, the federal government has relied on a system of accreditation to assess the quality of education (and authorize the distribution of federal and state funds).

Accreditation is provided on 3 levels – accrediting organizations that provide “institutional” accreditation which evaluates colleges or universities operating on the regional level (the U.S.A. is split geographically into 6 regions for that purpose) and operating on the national level; and specialized accrediting organizations providing accreditation of individual programs (e.g. distance learning programs).²¹

Independent of these distinctions, accreditation requirements are similar: the stress is on quality (of the provided education, but also of management), and its further improvement. In an attempt to monitor the monitors, both the U.S. Department of Education and the Council for Higher Education Accreditation (CHEA), an independent nongovernmental institution in existence since 1997²², oversee the quality of the various accreditation organizations. Currently 58 organizations are recognized by CHEA, 56 by USDE, and 36 by both.

The process of accreditation of educational institutions is very similar to the process of ISO certification; it is time-consuming and requires extensive preparation of materials by

²¹ It is necessary to emphasize that the U.S. accreditation system is not prohibitive, i.e. institutions without accreditation are allowed to provide education. However they cannot access federal funds, which tends to be the major source of income of nonprofits and for-profits alike.

²² Similar institutions existed for more than 40 years before 1997.

the organization. After submission of a written application with all the required documents (a thoroughly detailed description of all the provided programs and employed faculty), and self-assessment of the institution, on-site visits organized by the accreditor follow. These on-site visits are typically performed by experts in the field, i.e. they are peer reviews²³ (www.ed.gov/admins/finaid/accred, www.chea.org).

The performance of the U.S. system of accreditation of institutions of higher learning is not undisputed. Ortmann (1997, 2001), for example, has proposed that the astonishing emergence of a rather successful – by various measures – for-profit post-secondary education sector in the U.S.A. can only be explained by the inefficiency of traditional colleges and universities. This, of course, was something that accreditation was meant to prevent.

Maybe not surprisingly, many educational institutions have sought ISO certification. A simple google search with the keywords “iso higher education” yields currently more than one million hits, many of them illustrating the (attempted) application of ISO to educational institutions. We are not aware of persuasive studies that document the success of ISO certification to educational institutions.

2.d.3. Self-regulation? Codes of conduct?

Yet another form of quality assurance is self-regulation, i.e. the voluntary acceptance of a code of conduct by the members of a club. This code is usually created by an ‘umbrella’ organization, an organization providing services to operating institutions in a certain field, or by a group of organizations with a similar purpose. Signing of the Code means the organization is voluntarily willing to follow the rules and regulations listed there.

Examples of this type of regulation abound (Wyatt, 2004). As regards the fundraising industry we can mention the German Deutsche Spendenrat (www.spendenrat.de) or the

²³ Despite the fact that the review is performed by peers, the process cannot be considered self-regulatory. The regulatory body is a distinct, private entity that only cooperates with experts in the field.

Czech Donors' Forum (www.donorsforum.cz). The main problem with codes of conduct is their reliance on self-reporting, i.e. the organizations are trusted to follow the regulations without any follow-up checks, leaving significant space for abuses and provision of false information. We believe that the rather meager success that both organizations had in their respective countries is a result of the structural problems that affect these self-regulated systems. Nunez (2001) provides an insightful model of self-regulation and shows that self-regulatory organizations typically have little incentive to monitor quality and to reduce fraud, at least without public parallel regulation.^{24 25}

Recall that, until 2001, ZEWO was more akin to a self-regulatory collective. As mentioned, the structural problem (“credibility problem”) that this organizational form brought about prompted a radical reorganization towards consumer protection which significantly reduced the influence of the fundraising organizations, seemingly to the benefit of society at large. The trick is to find the right balance of independence and involvement, of reasonably disinterested investigation and informed standards.

3. Discussion of various systems

Below we identify the commonalities and main differences between the systems described above in section 2 along two dimensions: first, internally or externally developed and imposed standards (where the label “external” captures the independence of the issuing agency from applicants), and second, self-reported data or data produced through “investigators”. In the following table we classify the systems described in section 2 in accordance with these two dimensions.

²⁴ In some respects, Nunez (2001) explains well the bargaining game that has taken place over the past year, and continues to take place, between the Senate Finance Committee in the U.S. and the nonprofit sector there.

²⁵ In essence, they are prone to violate one or more of the three criteria identified by the the Institut fuer Ökologische Wirtschaftsforschung (see footnote 19 above): the independence of the issuing agency from applicants, the objectivity of the criteria/the degree to which the criteria go beyond legal or regulatory requirements, and the transparent development of the criteria/the thoroughness with which the evaluations are conducted.

Of course, the two dimensions that we choose are ideal types; one almost never finds them in such purity. For example, even investigators of certification agencies such as CBF or DZI rely to some extent on self-reported data.²⁶ The key difference is that investigators can force applicants in principle to divulge data that otherwise they might have chosen not to reveal. This changes the nature of the information revelation game significantly.

		Standards set	
		Internally	Externally
Information provision	Self-reported	Codes of conduct (Deutsche Spendenrat, Donors Forum)	IRS Form 990, GuideStar
	Investigated	U.S.A. accreditation (?)	Certification systems, ISO

A system based on self-reported data has one important advantage: even though there are some internal costs related to the reporting of the data, it is cheap. Unfortunately, the value of data provided by self-reports is likely to be of inferior quality even in the best of circumstances (i.e. in situations where a club might understand the importance of truthful and complete reporting). A system based on self-reports also requires significant interest and knowledge of consumers (i.e. will they read the provided information, and will they understand it?), as well as sufficient information flows (i.e. consumers will relate to each other their insights about the organizational realities of the firms that they look into). If these conditions, which are clearly necessary conditions but not sufficient ones, are not met, the system leaves significant room for abuse and misrepresentation (e.g. the problems with IRS Form 990 reporting described in section 2.a).

²⁶ In the extreme one could argue that all data are ultimately self-reported. But surely there is a difference, both in scope and in quality, between data reported from Form 990 (especially if there are no tangible consequences attached to misrepresentation), and the kind of data generated by the kind of structured data generation process that CBF or DZI use.

A system based on data produced through “investigators” has corresponding disadvantages and advantages. The acquisition of the data is likely to be more expensive – possibly significantly more expensive – but the value of these data is likely to be higher. The question is whether these expenses are an investment worth its money. In section 4 we discuss economic models of quality signaling which suggest that the answer can be both yes and no. The challenge of a proper design is to avoid the ‘no’ answer. It turns out that the answer hinges importantly on the costs it takes to detect “bad apples” (the detection probability) and the social welfare (in the form of savings in transaction and information costs, and other welfare improvements that are prompted by such a system).

As to our distinction of standards, our intuition suggests that standards set internally are likely to be less binding than standards set externally. The rules imposed by the IRS, for example, seem more binding than those imposed by codes of conduct that a club-like set of organizations might report. The problem is that in order to get firms to submit to externally set standards one has to force organizations legally or convince persuasively that indeed there are gains to be had for those that are competent and intend to play by the rules. As we have documented, although we believe that there are persuasive arguments for a certification system, it is sometimes not easy to persuade enough organizations to take the risk. If the system is designed without the participation of key players in the target market,²⁷ then the standards may overlook important industry characteristics. Even if the certifier manages to avoid this design problem and create the standards carefully and correctly, the target organizations may still feel the rules are imposed on them (similar to legislation but without the enforcing powers) and may resist participating. The case of the English certification is arguably an example of a failure of this type.

The main advantage of a self-regulated system that determines its own standards then is the involvement of the target organizations. Unfortunately, this may also be the major disadvantage, in that the involvement may lead to an inability to overcome opportunistic and shortsighted behavior. Lack of transparency and accountability are almost guaranteed

²⁷ All stakeholders’ groups shall be involved: target organizations, donors, and government representatives.

in situations where tightly-knit groups of people interact. The self-assessment of such a group of peers is not likely to be as detached as that of external evaluators. Again, the ZEW decision of 2001 seems to illustrate the problem.

The optimal design of a quality assurance system must avoid the threats identified above; the evidence reviewed above seems to suggest that independent investigators may be a key component of any promising problem. That said, while external standards are important, it is equally important to make sure that a critical mass of target organizations will buy into the basic idea, its design and implementation.

4. The economics of certification

4.a. Commonalities

Even though, as we have documented, there are many variants of certification models, there are some interesting commonalities:

First, candidates for a seal of approval voluntarily provide information that often goes well beyond the legal (accounting) requirements. How much more is arguably the key design and implementation parameter of a certification agency, for it is likely to limit the coverage the certification agency can provide. Closely related is the issue of how likely a certification agency is to catch a bad apple, which can spoil the reputation of the seal of approval (and the good apples).

Second, candidates for a seal of approval not only send a signal, but send a costly signal, through out-of pocket expenses (e.g., the examination fee that they have to pay) as well as the costs it takes to collect the requested information. None of these costs of course matters substantially in the GuideStar model, so we would expect systematically lower signaling and separating effects in that context unless GuideStar injects more information gathering components into its data collection efforts. But any such attempt would increase the costs of doing business significantly.

Third, most of the systems that we considered above focus on organizations raising funds nationally, rather than locally. The national focus may result from the fact that the payoffs from certification are higher on the national level (where building a reputation is probably much more expensive); on the local level building one's reputation may be less expensive and hence become a viable alternative. But even here, as the system franchised by Maryland Nonprofits suggests, certification could be of some value.

Fourth, all current certification providers use essentially one disclosure rule: the seal of approval. They do, for example, not rank certified organizations, nor do they provide full disclosure of their findings, although they can, of course, adjust their specific disclosure rule (or, in other words: the toughness of their standards) in many ways. Indeed, very little additional information is made public. In most cases the organizations are assured that the materials they provide to the certifier are confidential and will not be made public.

Fifth, organizations such as CBF and DZI have managed to build their reputations quite quickly. Bekkers (2003), for example, reports that the recognition rate of the CBF seal of approval almost doubled over the two-year span from 2001 to 2003 and was known by one third of the population at large in 2003 and by half of that part of the population that gives. Intuition suggests that these recognition figures translate into higher giving to those that are certified, although direct evidence does not seem to exist. Indirect evidence, however, exists in the form of the number of applications and the fact that firms that initially refused to sign on, often do later.

Sixth, all certification providers are nonprofits, with CBF and DZI being funded significantly, albeit decreasingly, with state money in various guises. To the extent that these certification agencies do provide a public service, public subsidies seem not unwarranted. In fact, in light of the influence that large fundraising might otherwise have, public subsidies seem warranted. And, in light of ever-increasing demands on

government resources, the question of self-sustainability, however, is not likely to go away any time soon.

4.b. Why? What theory says ...

Why would a company pay out-of-pocket and significant personnel expenses to be certified? Unless the company is irrational, it has to have the expectation that there will be a payoff that makes the investment worthwhile.

It turns out that economists have thought about such mechanisms for a while. In the language of economics, the willingness to provide the requested information – at substantial out-of-pocket and personnel expense – is a costly signal of one’s “type”. The signal induces a “separating” equilibrium in which participating players reveal themselves as “good” types, while those that do not participate are revealed as “bad” types. Interestingly, the good types do not have much of a choice. Once a critical mass of participating firms has been reached, consumers will view those trustworthy firms that might not want to go through the certification process for one reason or another as not trustworthy. Hence, the trustworthy types have little choice but to get the seal (unless they are able to acquire a reputation of their own, which is unlikely to be a less costly strategy). The situation is similar, for example, to the incentives of those who are thinking about acquiring an advanced degree. The pain of getting such a degree is rather high for those who are not well-equipped to attend a particularly demanding program but might want to misrepresent themselves to potential employers.

So again, then, why would a company pay out-of-pocket and significant personnel expenses to be certified? The key to the answer lies, to our mind, in the demand shifts that are prompted by a successful separating equilibrium. Succinctly, the demand curve shifts out on the good types while it shifts in on the bad types. This shift may be budget neutral in the sense that the total volume of giving remains the same, but it doesn’t have to be. In fact, within limits a nonprofit sector that is trusted will on average be able,

ceteris paribus, to collect more funds than one whose reputation is shot. The evidence in Bekkers (2003) is suggestive of such a mechanism.

Several rather technical papers have been written on the topic of certification (although the certifiers are sometimes called different names, such as intermediary). In the present context the following papers are of particular interest to us: Biglaiser (1993), Biglaiser & Friedman (1994), and Lizzeri (1999).

Biglaiser (1993) shows that an intermediary indeed has the potential to increase the welfare of society in situations with asymmetric information. He considers an ongoing market in which buyers buy one unit of an experience good and sellers sell one unit of the experience good. The good has either a high or low quality, and this quality realization is pre-determined but unobservable. Thus, the moral hazard problem of sellers is assumed away. The intermediary increases the welfare of society by increasing the speed with which the market functions. This is possible because, as the only agent in the market, the intermediary buys more than one unit of the good, and therefore gains experience faster. The intermediary does not cheat, because the short term gains from selling low quality goods for a high price are outweighed by the ‘infinitely’ repeated profits accruing to the intermediary who stays in the market for a long period (forever) and who maintains his reputation.

Shortcomings of Biglaiser’s model were addressed in a follow-up paper by Biglaiser & Friedman (1994). Here the authors address the role of an intermediary in situations where the sellers choose the quality of the goods they sell. It is shown that the intermediary is able to mitigate this problem as well, and again increases the welfare of society.

While the models by Biglaiser and Biglaiser & Friedman incorporate considerations of reputation and highlight the information advantage of the intermediary over other buyers, they neglect a feature that is of importance in the present context: the decision process of the intermediary. Lizzeri (1999) focuses exactly on this aspect using a different modeling approach: he analyzes the asymmetric information problem in a one-shot game with two

uninformed buyers, one informed seller, and one or more intermediaries. The intermediary provides the seller with an opportunity to reveal his quality, if the seller chooses to do so; the intermediary, through the choice of a disclosure rule (such as full disclosure, or disclosure of grades, or no disclosure) and a fee charged for certification, reveals some of the information to the buyers. Lizzeri assumes that the intermediary can assess the quality of the seller at no cost, and that the buyers appreciate the quality revealed to them through the intermediary. Technically, Lizzeri solves for sequential equilibria for various specifications of this game.

While the model is rather abstract and assumes away several important considerations (such as reputation as an alternative means of information transmission, cheating of the intermediary, or imperfect detection of quality), it elucidates some important issues concerning certification.

Assuming that the intermediary chooses to fully disclose the information he obtains, Lizzeri identifies a separating equilibrium with 'good' sellers asking for certification, and 'bad' sellers not asking for certification, rationalizing the kind of certification systems that we seem to be able to observe in Germany, the Netherlands, or Switzerland. In contrast, in those cases where the certifier chooses no disclosure, an undesired pooling equilibrium emerges in which all the sellers ask for certification, the intermediary awards it to all, and in so doing captures all the surplus but deflates the value of the certificate to zero. Unfortunately, a profit maximizing intermediary always chooses the second equilibrium, ensuring himself maximum possible profits. Lizzeri analyzes other possible extensions of the game: he examines, for example, a scenario with several intermediaries, and shows that competition among intermediaries shifts the power to consumers who end up completely informed.

As mentioned, the model presented by Lizzeri (1999) is rather abstract, but to the extent that it highlights in a stark manner certain features of theoretical equilibria (some of which we seem to see implemented in real life), it helps us understand better the workings of these institutions. Particularly, it points out a significant threat related to

certification: as we observe no disclosure being used by most agencies considered, we have to keep in mind that their temptation to shift to the pooling equilibrium by certifying most of the organization in the market is rather high. The problem is due to the profit-maximizing status of the agency in the model, which highlights the need to carefully monitor the enforcement of the non-distribution constraint in the certification agency we attempt to build. The nonprofit status of the certification agencies discussed in section 2.b. seems an effective means of counteracting that temptation.²⁸

According to the model by Lizzeri it might seem optimal to build two competing agencies and in this way force them to behave optimally. However, before drawing such a conclusion, it is first necessary to examine whether the market is sufficient to allow the existence of more than one certification organization, since in most cases even the one organization needs to be subsidized by the state; and subsidizing two organizations is likely to be more expensive than monitoring one organization carefully.

5. Discussion and conclusion: Toward the design and implementation of certification systems in transition economies

Michael (2004) argues that the time has come to walk the talk: it is time to get away from public exhortations and other forms of moral appeals and to start thinking hard about the design of incentive-compatible and effective anti-corruption measures. We are very sympathetic to these sentiments.

When it comes to consumer protection, we encounter sound but incomplete economic theory. We also encounter systems in other countries that work reasonably well. But reasonably well does not mean optimal. More importantly, these systems are in place in places where both legal enforcement and reputation have some bite.

²⁸ In personal communication, Wilke stressed the importance of this point and argued that this problem might ultimately undue the Maryland Nonprofits model. We are sympathetic to that concern. Wilke also pointed out that the kind of complementary donor advisory services that DZI provides, as long as they are

In this article we have discussed a form of enforcement that relies much less, or not at all, on the state, and that relies on the market only indirectly: Certification agencies force their members to reveal their (good) type through costly signals that can be “engineered” to induce a separating equilibrium. We have discussed the viability of this system of enforcement in environments where state and market have failed to deliver a satisfying degree of quality assurance, and have also discussed related information systems and systems of quality assurance.

Important questions – indeed questions that should be answered by any real-life version of a certification system – are yet not answered in a completely satisfactory manner. We enumerate these questions below to remind the reader of the complexities of the design and implementation problem:

- What exactly is the trade-off between the scope, and hence cost, of certification and the welfare benefits that can be captured this way?
- How strong is the demand shift, for individual organizations as well as the whole sector, that trustworthiness buys? Does it always pay off?
- How strong a demand shift will “bad types”, which got certified by mistake, generate?
- What industries, or industry segments, are certifiable?
- What is the critical mass of key members of targeted industries that one needs to get on board to launch a certification agency with a reasonable degree of confidence?
- How independent should the certification agency be a) in the setting of standards and b) in the certification process proper?
- To what extent should such an agency be financed from public funds?
- What other tasks should a certification agency undertake?
- How crucial is it that certification be done “in-house” (i.e. how much is to be gained by in-house “investigators”)?

paid either by the government, or by a public that values the provision of non-seal information (including warnings), can have a similar salutatory effect. We agree with that argument, too.

- How important are industry-specific assessment instruments?
- Who monitors the monitor?
- Can self-regulation ever be a viable alternative to certification?

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