DIFFERENTIATED REGULATION: 
THE CASE OF CHARITIES

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Abstract

The increasing number and influence of charities in the economy, allegations and evidence of fraud and mismanagement, and the need for information to inform policy, are all reasons for the establishment of charity regulators. Public interest and public choice provide underlying theories explaining charity regulation which aims to increase public trust and confidence in charities (and thus increases philanthropy), and to limit tax benefits to specific organisations and donors. Disclosure-based regulatory regimes are a common model for charities regulation in many jurisdictions. Nevertheless, these can be resource intensive for the regulator and regulated charities, and growing pressure on government budgets requires efficiencies to be found.

This paper proposes regulation differentiated according to charities’ main resource providers. This could reduce cost and increase the regulator’s effectiveness through focusing effort. In addition, this differentiation segments charity types according to the theories that explain why these organisations form and operate. We demonstrate the feasibility of such segmentation by use of cluster analysis of data on New Zealand registered charities and show which charities could benefit from differentiated regulation.

Keywords: Charity Regulation; Nonprofit Organisations; Regulation Efficiency; Differentiated Regulation
Differentiated Regulation: The case of charities

1. Introduction

To address calls for greater accountability and transparency from organisations engaged in ‘good work’, a number of jurisdictions have recently established charity regulators (for example, establishments include the Australian Charities and Not-for-profits Commission in 2012, the Charity Commission for Northern Ireland in 2010, and in 2006, New Zealand’s Charities Commission and Singapore’s Commissioner of Charities). In addition to responding to “scandals and doubts about public trust and confidence” (Connolly & Hyndman, 2013, p. 946), some calls for regulation are from those concerned that public policy would otherwise be undertaken in a vacuum, due to a lack of knowledge about the size and reach of the charitable sector (for example, Ferguson, 2005).

While many nonprofit organizations are required to comply with ‘business’ regulation (for example, Occupational Health and Safety), this research focuses on regulation designed to monitor the operation of organizations that are defined in law as charities. In many jurisdictions, there are specific benefits available to registered charities, which include: exemption from taxation on income (specifically surpluses), reduced state and local taxes, preferential access to government and philanthropic funds, and taxation rebates for donors (Abramson, Salamon, & Steurle, 2006; Breen, Ford, & Morgan, 2009; Smith, 2012). Governments have good reason to support charities and philanthropists, as these actors can reduce the burden on state funds (Hyndman & McMahon, 2011; Mayer & Wilson, 2010). Nevertheless, governments also regulate to restrict the number and type of organizations that can continue to avail themselves of these taxation and other benefits. Such regulation may also increase public trust and confidence in this sector; and potentially increase philanthropy (Breen, 2009).

Yet, the economic downturn from 2009 and general pressure on government budgets has meant that charity regulators have been affected by government cost-cutting measures (Mayer & Wilson, 2010), thus efficiencies are required. This research asks: what is an optimally efficient regulatory strategy that will increase public trust and confidence in cost-effective ways? New Zealand data utilised in this research supports the proposition that not all of the charities registering with their regulator in order to avail themselves of benefits require government oversight, as they already have primary resource providers who exercise oversight responsibilities. We posit that, instead of spreading reduced regulatory resources ever-more thinly, differentiated regulation provides a useful strategy for charity regulators to focus regulatory effort, increase effectiveness and reduce costs.
Differentiated regulation requires an effective segmentation of charities according to their main resource providers. In this research, we demonstrate (using cluster analysis) that such segmentation can be achieved, and that it is useful to the development of differentiated regulation and regulatory theories. Such differentiation also links to specific theories explaining why these organisations form and operate.

The remainder of this paper is organised as follows. In section 2 we discuss the theories that explain why charities form and operate. In section 3 we review the arguments for regulation. In section 4, we introduce differentiated regulation. In section 5 we present our empirical analysis to demonstrate the feasibility of segmenting charities consistent with differentiated regulation. Section 6 concludes the paper with discussion of our results and identification of opportunities for further research.

2. The charities sector

The rise of charity regulators is related to the increasing number and reach of nonprofit organizations in general and charities in particular, especially as governments increasingly contract with charities to deliver social services (Hyndman & McMahon, 2011; Mayer & Wilson, 2010). This section overviews the major economic theories describing why charities emerge and therefore who their main resource providers will be. These are: market failure, government failure, voluntary failure, and contracting for ‘trust goods’. In the last part of this section, we highlight the strident calls for regulating these organizations.

2.1. Theories explaining the rise of the sector

Market failure and government failure can explain why organizations form which deliver public/collective goods and services and do not distribute profits to owners. These organizations are likely to receive funds from donors, governments and, to a lesser extent, payment from service recipients. Rose-Ackerman (1986) argues that market failure occurs when goods can be delivered at a lower net cost (after the cost of contracting) by nonprofit rather than for-profit organizations. This will occur when the nonprofit organization is prepared to earn less than the cost of capital, and/or draw on voluntary labour donations. Nonprofit providers cater to those who cannot afford to pay the market price and thus can supplement the work of for-profit providers who will service only those clients who can and are willing to pay the market price. They will seek funding from donations (including bequests and sponsorships) and, because market failure also occurs in relation to the provision of public or collective goods, government will also be a major resource provider. In respect of public goods, for-profit organizations are not inclined to deliver these goods owing to free-riders.
Government can reduce such market failure through taxes and incentives to encourage service provision by others (Weisbrod, 1988, 1989).

While governments may use taxes and incentives to remedy market failure, nevertheless, when government is forced to step in as a provider or major funder, services it supplies tend to be homogeneous, not cognisant of diversity in communities, and hence government failure can occur. Nonprofit organizations emerge to reduce government failure by meeting the diverse needs of specific (heterogeneous) communities (Weisbrod, 1989), drawing on resources from government, donations, bequests and sponsorships.

The extent to which nonprofit organizations can continue to operate is dependent on such external funding and, without sufficient patronage or government support, they will fail (Salamon, 1987 terms this “voluntary failure”). Studies utilising this theory include Sutton, Baskerville and Cordery (2010) who analysed the failure of a national charity as it lost legitimacy with the donating public and government. Robbins and Lapsley (2008) also utilised the theory to analyse voluntary failure in the Irish hospital charitable sector, citing the reduction in resourcing as inflation impacted endowment funds, donations fell and costs rose.

A further reason for the rise of nonprofit organisations is provided by Ben-Ner (1986). When information asymmetry limits consumers’ ability to assess service quality, they are more likely to form their own organizations to ensure quality, or transact for these ‘trust goods’ with a nonprofit organization (Ben-Ner, 1986). Trust good transactions include, for example, when a child commits their parent with dementia to an aged care facility. Here, they cannot observe the quality of care, nor may the parent be able to adequately inform them. In these and similar situations, member management of nonprofit member-based organizations signals that the services can be obtained at a cost and quality that the members prefer (Cleveland & Krashinsky, 2009). Further, Cleveland and Krashinsky (2009) show that, in well-developed markets, these nonprofit providers also provide higher quality care than for-profit providers. While they may be effective, yet Weisbrod (1989) notes that these organizations’ managers have less incentive to be efficient than managers in for-profit businesses, therefore they require greater monitoring of their financial and social performance. The main resource providers – members who have formed and who fund the organisation – will take responsibility for this task.

From this brief explanation of market failure, government failure, voluntary failure and trust goods, it follows that nonprofit organizations are a significant part of the social infrastructure.
2.2. Support through taxation relief

In addition to supplementing government services in basic areas such as, health and social services, the charity sector includes organizations that enrich cultural diversity within society (for example, arts organizations), contribute to individuals’ well-being (for example, sports organizations) and in so doing, develop social capital within communities (Bryce, 2005). Governments must decide which of these non-market additions to public and collective goods they should support and how. Often they exempt charities from certain taxes and provide tax rebates to donors (Mayer & Wilson, 2010).

Fries (2003, p. 8) notes that charities provide opportunities enabling “citizens to contribute to the public good on their own initiative”. Citizens may offer funds, voluntary labour, labour at a reduced cost, or donate goods, thus enabling a nonprofit organization to reduce its service costs (James, 1987). When government is also a funder of these goods, it will also seek to encourage philanthropy and thus reduce demands on it to provide more funding. Philanthropy should grow when there is increased public trust and confidence in these charities; Breen (2009) notes that philanthropy will be more forthcoming and better targeted if fundraising regulation is effective.

A major tax benefit often extended to charities is an income tax exemption on surpluses from trading activities and income from investments. Tax-exempt bodies potentially enjoy a competitive advantage over for-profit businesses; this advantage is further extended if they use volunteers to deliver goods and services (Dalton & Casey, 2008). Yet, nonprofit trading concerns could be disadvantaged by their limited access to finance and credit. Further, a lack of horizontal equity exists between the nonprofit, for-profit and public sectors, as public sector organizations are both tax-exempt and also potentially have better access to credit and finance. Accordingly, income tax exemption is often viewed as appropriate to recognise nonprofit organizations’ activities.

2.3. Calls for regulation

Financial and governance scandals have seen increasing calls for charities regulation (Ferguson, 2005; Gaskin, 1999). For example, Fremont-Smith and Kosaras (2003) found 152 reported cases of fraud in US charities, yet acknowledged that these were only the ‘tip of the iceberg’, as many instances of fraud are not reported in the media. Further, Gibelman and Gelman’s (2004) international research found wrongdoing in charities included theft, misconduct, excessive compensation, and mismanagement of resources. It is unsurprising, therefore, that declining public confidence in charities (due in part to such scandals) has led to calls for enhanced charity accountability and regulation (Gaskin, 1999; Gibelman & Gelman, 2004).

Due to the sensitivity when resources provided by government and the public are defrauded, regulators have responded by increasing the regulatory scrutiny of the charity sector, including
requiring charities to report performance if they are to enjoy taxation concessions and other
benefits (Mayer & Wilson, 2010). Nevertheless, the disparity in charity size is one factor that makes
regulation of charities a ‘complex problem’ (Mayer & Wilson, 2010). For example, Mayer and Wilson
(2010) note that 75% of charities are small (expenditure is less than US$500,000) and demands for
disclosure compliance may be burdensome for these charities. Enforcement barriers are a further
issue; including regulators’ constrained resources (Mayer & Wilson, 2010). Design of the appropriate
form of regulation is therefore challenging.

3. Arguments for charity regulation
A number of theories of regulation and the fact that the need and imposition of regulation is both
contextually and temporally specific, make discussions of regulation complex (Hantke-Domas, 2003).
While neo-classical theorists discourage public regulatory intervention, the recognition that markets
are not perfectly efficient has given rise to two rationales for regulation - public interest (as argued
by Stigler, 1971), and public choice theory (as argued for by Peltzman, 1976).

The public interest theory of regulation asserts that regulation is necessary to deal effectively with
substantive resource distribution problems and is within the rational-economic perspective
(Christensen & Lægreid, 2006). Public interest theory argues that business operations prefer their
private interests rather than the public interest and that, due to information asymmetry, regulation
is needed to protect the public interest. This theory specifically acknowledges market failure
(Chalmers, Godfrey, & Lynch, 2012). Regulation may be used to reduce the likelihood that a
monopoly will under-provide a good or service. A regulator may also facilitate activities to address
information asymmetries and assist fair distribution of resources (Hantke-Domas, 2003). This could
be applied to charities in that, for example, a regulator focused on fundraising may monitor whether
charities’ funds (donations and grants) are applied appropriately to a charitable purpose and thus, to
improve confidence in the ‘donor market’ (Breen, 2009; Cordery, 2013).

Public interest theory suggests that government may also regulate to restrict entry to ensure public
safety and quality, often building (or supporting) a market to efficiently establish prices and quality
(as would happen for a donor market) (Chalmers et al., 2012; Christensen & Lægreid, 2006; Stigler,
1971). Mechanisms for evicting or punishing miscreants are also tools of restrictive entry regulation
and (as can be seen from the newly established regulators) much effort of new regulators is applied
to registration and compliance with entry restrictions. Regulation mandating organizational
disclosure of specific issues (especially financial statements), is less interventionist than regulation
that restricts entry to a particular market, and is a common policy tool (Breen, 2013; Solomons,
1978). Financial reporting regulation within the securities markets began as a reaction to insufficient
voluntary disclosure to maintain an internationally efficient marketplace (Solomons, 1978). By restricting incentives and opportunities for reporting manipulation, regulators aim to restore market confidence, encourage investor participation, and improve issuers’ governance (Solomons, 1978). Such regulation for disclosure is likely to be in the public interest, but will require regulated organizations to collect and process new information, increase their dissemination and accept assurance costs. Charity regulators take a similar approach, but often reduce the reporting burden on smaller charities in recognition of those costs (Cordery, 2013).

Public choice theory asserts that most regulation is merely a tool for addressing perceived problems, and that often the promise of regulation serving the public interest is not realised. This is due to rational ignorance, the self-interest of the politicians and public servants who regulate, and the possibility of regulatory capture (Christensen & Lægreid, 2006). Peltzman (1976) notes that rational regulators will seek to maximize political returns, rather than purely economic returns. Extrapolating this argument to the charities sector suggests that charity regulation may be perceived as “good” politically, especially when government financially supports charities, but such regulation could increase charities’ costs and change resource flows without necessarily increasing donors’ trust and confidence. Therefore, public choice highlights the necessity for regulatory efficiency so that regulatory costs do not exceed benefits.

Regulators need adequate funding, if both their law-making and enforcement roles are to be effective. “Governments regulate charities in a variety of ways and through a variety of government agencies” (Mayer & Wilson, 2010, p. 689). For example, the United States (US) regulator is the Internal Revenue Service, and the tax department is also used in Canada. However in England and Wales, the regulator is an independent organisation, while in other countries it is within another government department (See Table 1). This is a structural decision which may be informed by the theoretical motivation to regulate, but also by historic structures in particular countries (for example, Irvine & Ryan, 2013).

Government regulators frequently require charities to register, file returns, and be subject to audit on a random basis (as presaged by Solomons, 1978). Further, some regulators choose to respond to complaints from the public through audits and enquiries. However, recent reports show that the US regulator, the Inland Revenue Service (IRS), examined merely 1.36% of returns from tax-exempt organizations in 2011 (ten years earlier it was as low as 0.29%), while the Charity Commission of England and Wales reported an audit rate of 0.33% (Breen, 2013). Since then, budget cuts have forced a re-assessment of activity. Yet Simon (1995) notes that, when charity regulators limit their audit activity in order to reduce regulatory costs, lawless activity can ensue. As an example of the
costs of regulation, Table 1 shows a summary of the cost data from seven different countries that currently have a charities regulator.

Table 1: Comparison of regulators, number of charities and costs as at April 2014

<table>
<thead>
<tr>
<th>Country</th>
<th>Number of registered charities</th>
<th>Cost of regulator (in local currency and €)</th>
<th>Costs (in €) divided by # charities</th>
<th>Independent?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>60,000 expected (1,643 currently)</td>
<td>AU$14m (€9.36m)</td>
<td>€156 (per expected number) €5,697 per current registrations</td>
<td>Yes, but the Australian Charities and Not-for-Profits Commission (Repeal) (No 1) Bill 2014 plans to disestablish it</td>
</tr>
<tr>
<td>Canada</td>
<td>86,000</td>
<td>CAN$29.6m (€19.44m)</td>
<td>€186</td>
<td>Part of Inland Revenue but reports directly to Parliament</td>
</tr>
<tr>
<td>England and Wales</td>
<td>165,000</td>
<td>£20m (€36m)</td>
<td>€121</td>
<td>Yes</td>
</tr>
<tr>
<td>Ireland</td>
<td>8,000 expected (0 currently)</td>
<td>€1m (£0.82m)</td>
<td>€125 (per expected number)</td>
<td>Yes</td>
</tr>
<tr>
<td>New Zealand</td>
<td>27,000</td>
<td>NZ$6.3m (€3.93m)</td>
<td>€120</td>
<td>No, from 2012 became a part of Department of Internal Affairs</td>
</tr>
<tr>
<td>Scotland</td>
<td>23,800</td>
<td>£3.05m (€3.71m)</td>
<td>€128</td>
<td>Yes</td>
</tr>
<tr>
<td>Singapore²</td>
<td>2,130</td>
<td>SING$6.4m (€3.69m)</td>
<td>€1,418</td>
<td>No, was Inland Revenue and now part of Ministry of Culture Community and Youth</td>
</tr>
</tbody>
</table>

It can be seen that the costs of emergent regulators (e.g. Australia) is high due to their establishment phase, while the regulators in England and Wales, New Zealand and Scotland operate on €120-130 per registered charity. Nevertheless, all have suffered budget cuts. To respond to shrinking government budgets, Mayer and Wilson (2010, p. 527) suggest that “options that look instead to self-regulation by charities or their supporters are therefore attractive”. From the theory analysed above, members were identified as having a particular interest in the charities they establish and support (Ben-Ner, 1986; Weisbrod, 1989). Freeman (1984) agreed that stakeholders’ management can reduce the need for government regulatory activity, while Fishman (2003) suggests that citizens

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2 The Singapore Commissioner of Charities is also concerned with Institutions of a Public Character (Commissioner of Charities, 2012)
should be empowered to actively leverage regulators’ efforts. Nevertheless, private individuals may lack “standing” or the legal ability to challenge charities’ decisions through the courts (Mayer & Wilson, 2010). The exceptions to this are members of charities and trustees or directors (Mayer & Wilson, 2010). How, therefore, can regulatory reform draw on such legally empowered parties and yet ensure that monitoring occurs?

4. Differentiated regulation

Regulatory reform is a key aspect of New Public Management, with early reformers seeking to ‘roll back the state’ and, more recently, to ensure better regulation (Christensen & Lægreid, 2006). This has also led to new means of regulation, from an institutional point of view and in respect of alternative regulatory practices (Hansen & Pedersen, 2005). These alternatives to traditional approaches include co-regulation (as can be seen, for example in fund-raising regulation in Canada (Phillips, 2012)), self-regulation, targeted taxes, and differentiated regulation. For example, when regulators seek to introduce higher standards for buildings or carbon emission, they may differentiate between new buildings or vehicles and old ones, through taxes or specific regulations. Vintage-differentiated regulation (grandfathering) holds newly constructed facilities and vehicles to a higher quality than pre-existing facilities (Gruenspecht, 1982; Stavin, 2006). A further example of differentiated regulation is also in the environmental space where, in a study of recycling policies, Feldman and Perez (2012) found that optimal social policies required different regulatory strategies depending on the individuals involved.

In respect of disclosure, New Zealand provides an example, as for-profit electricity distribution businesses are required to report against specific price and quality metrics, and yet consumer-owned electricity distribution businesses are exempt from this reporting (Commerce Act, 1986 s.54D). This exemption relates to the ability of consumer-owners to monitor the prices and quality of their own electricity distribution business in the manner described by Ben-Ner (1986) in respect of trust goods.

Thus, differentiated regulation allows regulators to scan the field and regulate only those that need it, or to regulate some participants differently from others. Joint monitoring by both regulators and stakeholders may be an option (Breen, 2009). For example, charities that rely on grants and/or donations from the general public (stakeholders) are more likely to file their financial statements with the regulator earlier (Reheul, Caneghem, & Verbruggen, 2012) and to subject their financial statements to audit (Kitching, 2009). While Weisbrod and Dominguez (1986) and Posnett and Sandler (1989) found that significant donors do analyse financial statements before donating, nevertheless Verbruggen, Christiaens and Milis (2011) argue that donors may not be as interested in
financial reporting as a government funder, raising questions over the ability of a diverse public donor group (who is not legally empowered) to monitor effectively.

If the costs of regulation are high, but there is no improvement in public trust and confidence, then it may be well-intentioned (consistent with public interest) but ineffective, or simply be a tool to promote the interests of politicians/regulators without necessarily being intended to be effective (as argued by public choice theory). In either case, tools to increase the efficiency and effectiveness of regulation should be considered. We propose differentiated regulation as an effective measure. In particular, we hypothesize that some charities will be more likely to benefit from regulation: these will be the charities that are funded mainly by public donations (and arise to combat market failure as argued by Rose-Ackerman, 1986) and/or charities that receive funds for social services delivery (and arise to combat government failure as argued by Weisbrod, 1988). It is these charities that government would seek to assess whether or not they are working in the public interest, as they would have been established in response to market failure or government failure (as noted by Rose-Ackerman, 1986; Weisbrod, 1988). We expect that other charities would be more likely to benefit from monitoring by their major resource providers – these may be member organizations with member managers (including deliverers of trust goods as argued by Ben-Ner, 1986), and those managed by trustees, such as philanthropists who seek to redistribute wealth, and providers of infrastructure to communities and other nonprofit organizations. For these latter, the argument is related not only to the reason for establishment, but also the standing of relevant stakeholders.

The following section describes an empirical study on New Zealand data which demonstrates the feasibility of segmentation and hence the practicality of differentiated regulation.

5. Empirical study

5.1. Context, costs and confidence

The data used in this research is from the register of the New Zealand Charities Commission which was established as an independent Crown Entity in 2005 to accept registrations from 1 July 2007. At the time of the data collection in 2012, the Charities Commission had reached a ‘normal phase’ of operation following its start-up and registration of charities. However, the Commission subsequently was transferred into a government department and is now known as Charity Services. The regulator experienced a prolonged gestation. Concern had been expressed that organisations were being structured as charities in order to utilise tax benefits for tax avoidance, and various bodies recommended that a new regulator be established to register and monitor charities (these included: New Zealand Working Party on Charities and Sporting Bodies, 1989; Newell, 1997; Working Party on
Registration Reporting and Monitoring of Charities, 2002). Charities that demonstrate one of these purposes are able to register and receive the benefits of registration. Furthermore, the lack of knowledge about the extent of government support to charities provided a strong impetus to charity regulation, as little data existed on charities’ incomes and the levels of donations made to them (Slack & Leung-Wai, 2007). Such information had the potential to be useful for policy-making as well as to restrict entry to charity-specific (tax) benefits.

The Charities Act 2005 (2005) enshrined in New Zealand Law the four heads of charity classified by Lord McNaughton in the well-known “Pemsel case” of 1891 (The Commissioners for Special Purposes of the Income Tax v. John Frederick Pemsel). This case has been foundational in decisions on appropriate charitable purposes and exemption from income tax in England and Wales (Gousmett, 2009) as well as New Zealand. The main purposes that define a charity are: the relief of poverty, the advancement of education, the advancement of religion, or other purposes beneficial to the community (Charities Act, 20052012 s.5(1)).

Following the establishment of the register, the number of registered charities grew steadily to 27,000 as at 2013.vi Each charity is required to file annually their financial statements and complete a question with the same data in pro-forma categories. They are also required to provide details of the charity’s officers and other statistical information. vii The cost of this regulatory regime comprises the direct costs of the regulator, the compliance costs for the registered charities, and the welfare costs associated with the change in resource allocation resulting from operation of the regime. We have no information on the latter categories of costs but the on-going costs of the regulator are €120 per registered charity as shown in Table 1. In addition to the registration process, the regulator carried out 634 investigations in 2011 (2.8% of registered charities) and 360 investigations in 2012 (1.48% of registered charities) (Charities Commission, 2012). In both years, more than 100 investigations remained uncompleted at year end.

It is unclear whether philanthropy has increased since the regulator has been established, however donation rebates to individuals have almost doubled from NZ$119 million in 2005 (Slack & Leung-Wai, 2007) to NZ$203 million in 2011, viii particularly following the removal of the tax-cap on donation rebates which was likely to result in more participants in the ‘donor market’ (see Cullen & Dunne, 2006). However, bi-annual surveys of public trust and confidence in charities evidence a decline in the number of respondents who have high trust in charities – from 58% in 2008 to 44% in 2012 (UMR Research, 2010, 2012).
In addition to donations, charities receive significant funds from government departments in the way of contracts and grants to charities of NZ$1.25 billion in 2006 (against total government expenditure of NZ$54.2 billion) (Department of Internal Affairs, 2007). Total contracts and grants are likely to be higher, as this figure did not include second tier payments. The data indicate that, while the regulation cost may not be significant for government, the government resources flowing into the sector by way of donation rebates and contracting, means it is important to ensure efficient regulation.

We now turn to the question of whether the charities can be segmented into different ‘types’, for example, those funded mainly by donations (and arise to combat market failure as argued by Rose-Ackerman, 1986), charities that receive funds for social services delivery (and arise to combat government failure as argued by Weisbrod, 1988), member organizations with member managers (including deliverers of trust goods as argued by Ben-Ner, 1986), those managed by trustees, such as philanthropists who seek to redistribute wealth, and providers of infrastructure to communities and other nonprofit organizations.

5.2. Analysis of “Types” of Registered Charities
Market failure and government failure theories suggest that donative and social services charities are most likely to register with a regulator to receive tax benefits (see Rose-Ackerman, 1986; Weisbrod, 1988, 1989) and yet others may register as well, adding additional regulatory costs in a constrained environment. We used data from the New Zealand Charities’ Register to determine whether, on the basis of revenue sources, the charities separated into different “types” which could be described based on their revenue, expenditures, assets and liabilities. We further were interested in whether or not any of these “types” could be called donative (as per Rose-Ackerman, 1986), social service charities (as per Weisbrod, 1988), membership charities (as per Ben-Ner, 1986), philanthropists seeking to re-distribute wealth, or providers of infrastructure to the community or other nonprofit organizations. Financial statements of a stratified random sample of 835 registered charities were extracted from the Register and analysed. The sample was stratified by the sector chosen by the charities from a list of twelve different sectors when they file their financial statements. Approximately half of the sample had expenditure of less than NZ$40,000 (425) and the remainder (410) had expenditure greater than NZ$40,000 but less than NZ$2,000,000. The population from which this sample was drawn comprised 95.96% of the total register. We excluded large charities that comprise the balance as they were likely to be more business-oriented than small- and medium-sized charities.
Financial data filed by the charities in a pro-forma document was downloaded, along with their annual financial statements which they were required to file contemporaneously. These latter were separately entered into a spreadsheet to check the validity of the pro-forma data filed with the regulator. This was undertaken due to the known errors in this and similar filings with regulators (Cordery & Patel, 2011; Keating & Frumkin, 2003). These organizations’ revenues and expenditures were converted to ratios and analysed to enable comparisons. Charities with zero total revenue were omitted from the analysis, resulting finally in a data set of 803 charities.

We then used cluster analysis on the data set of 803 charities. Cluster analysis (specifically K-means cluster analysis) was used because we were looking for “types” or clusters of charities which met most, if not all, of the following criteria:

1. The different “types” generated by the statistical algorithm should, as much as possible be very different in terms of their dominant source(s) of revenue. That is, the different “types” defined by the statistical algorithm should provide groupings which are intuitively and meaningfully different.

2. Individual charities should, as much as possible, clearly belong to only one “type”. That is, the mean percent of each revenue source should be very different from one charity “type” to another.

3. The different “types” of charities should each be very homogeneous. That is, the percent revenues should not vary a lot within each type.

4. The clustering algorithm should be reproducible. That is, when the cluster definitions based on the original data set of 803 charities are used in other data sets of charities, the charity “types” thus defined should also be very different, meaningful and homogeneous. For this reason, a second data set, a simple random sample of 296 further registered charities was used to verify the clustering algorithm.

In order to be useful, clusters should capture the data’s natural structure (Tan, Steinbach, & Kumar, 2004). K-means clustering is the most widely used clustering algorithm and assigns each case to one partitional cluster, rather than allowing over-lapping clusters (Tan et al., 2004). Thus, K-means clustering does not allow nested or hierarchical sub-clusters, so that data should belong to one cluster only. Further, K-means clustering is a complete clustering system rather than the partial clustering achieved by DBSCAN density-bound clustering algorithms (Tan et al., 2004). Nevertheless, K-means clustering has the limitation that the user chooses the number of clusters to be used. Therefore, we first used hierarchical clustering to determine the best cluster number for the 803 charities in the file. It suggested four clusters. K-means clustering was then performed on the 803
charities with 4, 5, and 6 clusters. The four cluster model included two clusters with 300 or more members, while the five cluster model included only one large (300+) cluster. The six cluster model included one cluster with only 5 members, which would not allow for any rigorous descriptive statistics. We therefore chose the five cluster model as the most useful for analysis. We also (as noted above) validated the cluster algorithm with a second data set, as recommended by Tan et al (2004).

We next extended the description of the five clusters beyond the revenue ratios, to include an analysis of expenditure, liabilities and assets. This allowed us to further describe our clusters and assess their suitability; finally, we validated the cluster definitions with the second sample of 296 charities (140 small and 156 medium-sized). For each of these 296 charities, the distance from the centroid of each cluster (from the analysis of the 803) was calculated, and the charity was assigned to the cluster whose centroid was closest. We then examined the data from this second data set to determine if they had a similar distribution of revenues, expenditures, assets and liabilities to the clusters in the first data set, and to examine whether the clusters in the second data set were distinct and homogeneous. We used one-way ANOVA and Post Hoc tests to see how the percent revenue means and standard deviations in this new sample met or did not meet our criteria for an adequate categorization of charities, and how the clusters in this second set resembled, or not, the clusters from the exploratory cluster analysis on the first set. The results of the initial clustering and validation follow.

5.2.1. Development and Description of Clusters

In this sub-section we present the results from the clustering. The validation of the findings is discussed in section 5.2.2. Table 2 provides the overall results of the one-way ANOVA for the clusters based on revenue sources. As expected, since the clusters were defined by revenue sources, for all revenue sources the mean percents were significantly different by cluster. However, we were interested in how well the group means separated out by revenue source(s). We therefore examined the results of the Post Hoc tests (Tukey’s) to see whether the clusters fell into distinct groupings with respect to the revenue types. For example, from Table 2, we see that the revenue source “sponsorships” clearly separates the 5 clusters into two groups, which could be called high versus low levels of sponsorship, because there is no statistical overlap in the means. Considering all revenue sources, the Post Hoc tests indicate no more than one cluster overlapping for any comparison. This fits the requirements stated above to have group means that are very different, as well as small standard deviations within each cluster to establish a statistical difference. Thus we can conclude that each revenue type splits the file of charities into distinct groups of clusters.
Table 2: Results of ANOVA comparison of means by Revenue Cluster.

<table>
<thead>
<tr>
<th>Revenue Type</th>
<th>Overall F statistic</th>
<th>p-value</th>
<th>Post Hoc result: range of cluster means</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public/ Donations</td>
<td>1218.174</td>
<td>0.000</td>
<td>4 groups, 1,1,0 overlap: 3.56%-85.06%</td>
</tr>
<tr>
<td>Sponsorships</td>
<td>10.615</td>
<td>0.000</td>
<td>2 groups, no overlap; 0.00% - 4.99%</td>
</tr>
<tr>
<td>Goods and services</td>
<td>991.920</td>
<td>0.000</td>
<td>3 groups, 1 overlapping: 1.20%-72.42%</td>
</tr>
<tr>
<td>Bequests</td>
<td>9.581</td>
<td>0.000</td>
<td>2 groups: no overlap: 0.00%-3.80%</td>
</tr>
<tr>
<td>Investments</td>
<td>2370.176</td>
<td>0.000</td>
<td>3 groups, no overlap: 3.09%-92.20%</td>
</tr>
<tr>
<td>Gains/ Other</td>
<td>21.524</td>
<td>0.000</td>
<td>2 groups, no overlap: 1.28% - 12.94%</td>
</tr>
<tr>
<td>Members</td>
<td>203.494</td>
<td>0.000</td>
<td>2 groups, no overlap: 0.42%- 41.70%</td>
</tr>
<tr>
<td>Rental</td>
<td>1138.88</td>
<td>0.000</td>
<td>2 groups, no overlap: 0.74-73.43%</td>
</tr>
</tbody>
</table>

The next question is whether a consideration of all the revenue types together defines meaningful distinct clusters. Table 3 shows the means and standard deviations of the revenue sources by Revenue Cluster and provides names for each of these clusters. From Table 3, it can be seen that for each Revenue Source, one mean is clearly larger than the others (often several times larger). We can therefore say that the Revenue Clusters reflect different dominant revenue sources. Because of this, we have named the clusters according to their dominant revenue source. We called Cluster 1 the “Classic Charity” Cluster as 85.06% of its revenue is derived from public donations and 6.26% from goods and services – a total of 91.32% of income from these sources (SD=11.80). Further, Cluster 2 was named “Service Providers” as 89.10% of their income also derived from these combined sources (SD=12.82), but there was a much lower percentage (16.48%) from public donations, with the majority of their revenue (72.42%) being derived from goods and services. The revenues of the cluster were not widely diversified, except for the Cluster 3 charities which we termed “Member Organizations” and which had more diverse revenue sources. It can be observed from Tables 4 and 5 (below) that, although the clusters were defined on the basis of revenue, there were statistically significant differences in mean expenditures and in mean assets and liabilities. They are as follows:

- **Cluster 1: Classic charities:** receive the great majority of their income from public donations (philanthropy). They are differentiated from membership organizations and service providers, as they focus on charitable support, rather than members and services alone. They are second only to service providers in their expenditure on staff and services. In addition, classic charities have the most cash assets of all the charities identified in this taxonomy.

- **Cluster 2: Service providers:** receive most funds for delivering goods and services for government and expend most of their funds on services and staffing. Service providers are most likely to have short term loans – these will include creditors, staff accruals, and short term leasing arrangements, however they also hold a large percentage of their assets in cash, especially when compared to the member-based, infrastructure and trusts/grantor charities.
- **Cluster 3: Member organizations:** their main forms of income are from membership and sponsorship and, for the charities analysed, these were the main recipients of bequests (although it is not a large percentage of total income). In addition, these charities record the highest overhead expenditure of all the charity clusters and make the least amount of grants.

- **Cluster 4: Infrastructure providers:** provide facilities, structures and systems to support and coordinate front-line service organizations so that they in turn can deliver their missions more effectively. For example, these might be accommodation for a service, a campsite or community hall. These charities receive the majority of their income from rents and their expenditure on financing confirms their difference from other clusters. They are the largest owners of Property, Plant and Equipment and are most likely to have loans from members and other sources.

- **Cluster 5: Trusts/Grantors:** have the most short term investments and receive the majority of their funds from these investments. They also pay out the most grants and have low expenditure on other classifications such as staff and overheads.

### Table 3: Means and Standard Deviations of charities' revenue variables by Revenue Cluster

<table>
<thead>
<tr>
<th>Revenue Type</th>
<th>Cluster 1 (Classic Charity)</th>
<th>Cluster 2 (Service Provider)</th>
<th>Cluster 3 ** (Member organization)</th>
<th>Cluster 4 (Infrastructure provider)</th>
<th>Cluster 5 (Trust/grantor)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Public / Donations</strong></td>
<td>N= 395</td>
<td>N= 200</td>
<td>N= 64</td>
<td>N= 38</td>
<td>N= 106</td>
</tr>
<tr>
<td>(p = 0.000)*</td>
<td>85.06% ††</td>
<td>16.68%</td>
<td>15.51%</td>
<td>9.52%</td>
<td>3.56% †</td>
</tr>
<tr>
<td></td>
<td>± 14.98</td>
<td>± 16.55</td>
<td>± 15.68</td>
<td>± 15.40</td>
<td>± 8.89</td>
</tr>
<tr>
<td><strong>Goods &amp; services</strong></td>
<td>6.26%</td>
<td>72.42% ††</td>
<td>11.67%</td>
<td>3.96%</td>
<td>1.20% †</td>
</tr>
<tr>
<td>(p = 0.000)</td>
<td>± 10.44</td>
<td>± 19.51</td>
<td>± 13.10</td>
<td>± 8.86</td>
<td>± 4.94</td>
</tr>
<tr>
<td><strong>Bequests</strong></td>
<td>0.14%</td>
<td>0.0030% †</td>
<td>3.80% ††</td>
<td>0.0042%</td>
<td>0.04%</td>
</tr>
<tr>
<td>(p = 0.000)</td>
<td>± 1.82</td>
<td>± 0.0411</td>
<td>± 15.77</td>
<td>± 0.261</td>
<td>± 0.40</td>
</tr>
<tr>
<td><strong>Investments</strong></td>
<td>3.09% †</td>
<td>3.50%</td>
<td>8.07%</td>
<td>9.33%</td>
<td>92.20% ††</td>
</tr>
<tr>
<td>(p = 0.000)</td>
<td>± 6.36</td>
<td>± 6.60</td>
<td>± 10.86</td>
<td>± 14.36</td>
<td>± 14.07</td>
</tr>
<tr>
<td><strong>Members</strong></td>
<td>2.13%</td>
<td>3.65%</td>
<td>41.70% ††</td>
<td>0.42% †</td>
<td>0.78%</td>
</tr>
<tr>
<td>(p = 0.000)</td>
<td>± 5.67</td>
<td>± 8.07</td>
<td>± 31.69</td>
<td>± 2.48</td>
<td>± 3.65</td>
</tr>
<tr>
<td><strong>Rental</strong></td>
<td>1.54%</td>
<td>0.99%</td>
<td>1.33%</td>
<td>73.43% ††</td>
<td>0.74% †</td>
</tr>
<tr>
<td>(p = 0.000)</td>
<td>± 5.15</td>
<td>± 3.42</td>
<td>± 4.67</td>
<td>± 21.38</td>
<td>± 4.29</td>
</tr>
<tr>
<td><strong>Sponsorship</strong></td>
<td>0.36%</td>
<td>1.48%</td>
<td>4.99% ††</td>
<td>0.034%</td>
<td>0.00% †</td>
</tr>
<tr>
<td>(p = 0.000)</td>
<td>± 2.05</td>
<td>± 5.70</td>
<td>± 16.70</td>
<td>± 0.21</td>
<td>± 0.00</td>
</tr>
<tr>
<td>**Other *****</td>
<td>1.41%</td>
<td>1.28% †</td>
<td>12.94% ††</td>
<td>3.30%</td>
<td>1.48%</td>
</tr>
<tr>
<td>(p = 0.000)</td>
<td>± 4.84</td>
<td>± 4.64</td>
<td>± 28.73</td>
<td>± 10.62</td>
<td>± 5.53</td>
</tr>
</tbody>
</table>

* The p-value is from the one-way ANOVA of each revenue source by cluster.

** The membership cluster was very diverse with many charities receiving significant percentage of their revenue from 'other' sources.

*** Other includes revenue designated as “other”, “foreign exchange (and other asset revaluation) profits”, and “insurance claims”.

† Indicates the lowest mean for this variable.

†† Indicates the highest mean for this variable.
To achieve a visual representation of the distribution of the charities, we plotted the data using Multidimensional Scaling (MDS). MDS is a way of representing the distances or dissimilarities between cases into two- or three-dimensional space, as defined by the variables specified. For example, the MDS plot of the charities based on the revenue percent variables (Bequests, Goods and Services, Investment income, Membership, Public Donations, Rental, Sponsorship), considers how dissimilar the charities are from each other, based on the different values of these variables. In our case, a Euclidean metric was used (as was used in the cluster analysis). Once the charities data had been mapped (in eight revenue dimensions and viewed in two-dimensional space), they were labelled by their cluster. We could then determine visually whether or not the charities in the same cluster were close together with respect to these variables. The MDS plot of these variables identified by cluster is shown in Figure 1.

**Figure 1: MDS plot of charities clusters based on revenue patterns**

The MDS plot in Figure 1 separates out the clusters quite well in two-dimensional space. That is to say, the clusters as defined have quite different patterns of revenue. None of these clusters is far away from the others, but they are distinct. A few member charities do not fit the pattern well (top left), however the cast majority of charities separate into five distinct groups.

Table 3 clearly describes the differences in means between the Revenue Clusters. However, we also sought to ascertain whether there was a difference in other financial elements based on cluster type. The analysis of variance results in Table 4 show that the revenue-based clusters also have
different means for the expenditure variables. While they are not as marked as the difference in the revenue variable means, it can be seen that the patterns of expenditure map to the Revenue Clusters. These differences are further elaborated on in the definitions of the clusters above.

Table 4: Means and Standard Deviations of charities’ expenditure variables by revenue cluster

<table>
<thead>
<tr>
<th>Expenditure Type</th>
<th>Cluster 1 (Classic Charity)</th>
<th>Cluster 2 (Service Provider)</th>
<th>Cluster 3 (Member organization)</th>
<th>Cluster 4 (Infrastructure provider)</th>
<th>Cluster 5 (Trust/grantor)</th>
</tr>
</thead>
<tbody>
<tr>
<td>N= 394</td>
<td>N= 200</td>
<td>N= 63</td>
<td>N= 38</td>
<td>N= 106</td>
<td></td>
</tr>
<tr>
<td>Financing**</td>
<td>1.70%†</td>
<td>0.66%</td>
<td>0.17%†</td>
<td>5.71%††</td>
<td>1.77%</td>
</tr>
<tr>
<td>(p = 0.017)*</td>
<td>± 9.98</td>
<td>± 2.23</td>
<td>± 0.47</td>
<td>± 14.24</td>
<td>± 11.69</td>
</tr>
<tr>
<td>Fundraising</td>
<td>5.70%††</td>
<td>0.93%</td>
<td>3.01%</td>
<td>0.50%</td>
<td>0.21%†</td>
</tr>
<tr>
<td>(p = 0.000)</td>
<td>± 15.41</td>
<td>± 3.51</td>
<td>± 11.20</td>
<td>± 2.70</td>
<td>± 2.02</td>
</tr>
<tr>
<td>Grants</td>
<td>12.73%</td>
<td>6.17%</td>
<td>5.78%†</td>
<td>9.49%</td>
<td>41.66%††</td>
</tr>
<tr>
<td>(p = 0.000)</td>
<td>± 28.03</td>
<td>± 16.17</td>
<td>± 18.86</td>
<td>± 21.63</td>
<td>± 42.79</td>
</tr>
<tr>
<td>Overhead</td>
<td>29.87%</td>
<td>27.71%</td>
<td>38.94%††</td>
<td>30.85%</td>
<td>23.53%††</td>
</tr>
<tr>
<td>(p = 0.018)</td>
<td>± 29.66</td>
<td>± 24.22</td>
<td>± 31.38</td>
<td>± 26.39</td>
<td>± 33.49</td>
</tr>
<tr>
<td>Staff</td>
<td>20.36%†††</td>
<td>17.05%</td>
<td>8.16%</td>
<td>9.03%</td>
<td>1.88%†</td>
</tr>
<tr>
<td>(p = 0.000)</td>
<td>± 29.32</td>
<td>± 25.68</td>
<td>± 16.03</td>
<td>± 20.17</td>
<td>± 8.43</td>
</tr>
<tr>
<td>Services</td>
<td>16.06%</td>
<td>36.25%†††</td>
<td>25.76%</td>
<td>12.67%</td>
<td>8.22%†</td>
</tr>
<tr>
<td>(p = 0.000)</td>
<td>± 24.40</td>
<td>± 29.85</td>
<td>± 27.75</td>
<td>± 20.20</td>
<td>± 22.42</td>
</tr>
</tbody>
</table>

* The p-value is from the one-way ANOVA of each expenditure variable by cluster.
** Financing expenditure is spending on interest and leases.
† Indicates the lowest mean for this variable
†† Indicates the highest mean/s for this variable

Table 5 presents the means and standard deviations of charities’ assets and liabilities variables by Revenue Cluster. This also shows that there are differences in the clusters as they are defined (specifically in terms of investments in Trusts/grantors, Property, Plant and Equipment and Long-term borrowing by Infrastructure providers.

Table 5: Means and Standard Deviations of charities’ asset and liability variables by revenue cluster

<table>
<thead>
<tr>
<th>Asset and Liability Type</th>
<th>Cluster 1 (Classic Charity)</th>
<th>Cluster 2 (Service Provider)</th>
<th>Cluster 3 (Member organization)</th>
<th>Cluster 4 (Infrastructure provider)</th>
<th>Cluster 5 (Trust/grantor)</th>
</tr>
</thead>
<tbody>
<tr>
<td>N= 394</td>
<td>N= 200</td>
<td>N= 63</td>
<td>N= 38</td>
<td>N= 106</td>
<td></td>
</tr>
<tr>
<td>Assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>49.42%†††</td>
<td>41.26%</td>
<td>34.58%</td>
<td>11.82%†</td>
<td>22.58%</td>
</tr>
<tr>
<td>(p = 0.000)*</td>
<td>± 39.31</td>
<td>± 37.04</td>
<td>± 38.68</td>
<td>± 25.78</td>
<td>± 35.42</td>
</tr>
<tr>
<td>Short Term assets</td>
<td>5.08%</td>
<td>8.21%††</td>
<td>4.08%</td>
<td>2.39%†</td>
<td>3.41%</td>
</tr>
<tr>
<td>(p = 0.033)</td>
<td>± 14.82</td>
<td>± 18.32</td>
<td>± 13.56</td>
<td>± 8.26</td>
<td>± 14.36</td>
</tr>
<tr>
<td>Investments</td>
<td>17.99%</td>
<td>17.59%†</td>
<td>36.76%</td>
<td>17.61%</td>
<td>67.69%†††</td>
</tr>
<tr>
<td>(p = 0.000)</td>
<td>± 29.53</td>
<td>± 27.26</td>
<td>± 37.64</td>
<td>± 26.90</td>
<td>± 39.08</td>
</tr>
<tr>
<td>Property, Plant &amp; Equip</td>
<td>21.05%</td>
<td>28.56%</td>
<td>18.83%</td>
<td>65.81%†††</td>
<td>1.47%†</td>
</tr>
<tr>
<td>(p = 0.000)</td>
<td>± 32.55</td>
<td>± 34.67</td>
<td>± 29.12</td>
<td>± 36.35</td>
<td>± 7.98</td>
</tr>
</tbody>
</table>
### Liabilities

<table>
<thead>
<tr>
<th>Grants</th>
<th>8.02% ††</th>
<th>6.42%</th>
<th>0.95% †</th>
<th>2.31%</th>
<th>1.24%</th>
</tr>
</thead>
<tbody>
<tr>
<td>(p = 0.005)</td>
<td>±24.27</td>
<td>±19.88</td>
<td>±7.53</td>
<td>±11.02</td>
<td>±10.14</td>
</tr>
<tr>
<td>Long-term Borrowing</td>
<td>6.05%</td>
<td>7.24%</td>
<td>3.96%</td>
<td>25.38% † †</td>
<td>2.80% †</td>
</tr>
<tr>
<td>(p=0.000)</td>
<td>±21.55</td>
<td>±22.92</td>
<td>±17.22</td>
<td>±40.68</td>
<td>±16.50</td>
</tr>
<tr>
<td>Member Loans</td>
<td>0.27%</td>
<td>0.47%</td>
<td>0.00% †</td>
<td>2.93% † †</td>
<td>1.81%</td>
</tr>
<tr>
<td>(p = 0.044)</td>
<td>±3.48</td>
<td>±4.84</td>
<td>±0.0000</td>
<td>±14.07</td>
<td>±13.13</td>
</tr>
<tr>
<td>Short Term Liabilities</td>
<td>29.86%</td>
<td>33.75% † †</td>
<td>33.82%</td>
<td>27.07%</td>
<td>13.96% †</td>
</tr>
<tr>
<td>(p=0.001)</td>
<td>±41.59</td>
<td>±39.92</td>
<td>±42.00</td>
<td>±37.40</td>
<td>±33.60</td>
</tr>
</tbody>
</table>

* The p-value is from the one-way ANOVA of each expenditure variable by cluster.
† Indicates the lowest mean for this variable
† † Indicates the highest mean/s for this variable

### 5.2.2. Validation of the Revenue Clusters

As noted above, it is good practice to validate the cluster algorithm with a second data set (Tan et al., 2004). This confirmatory set (296 different registered charities) was clustered according to the Revenue Clusters defined on the original data set of 803 charities (see Table 3 above). We found very similar patterns of revenues, expenditures, assets and liabilities by cluster. For example, classic charities (Cluster 1) in the original 803 received 85.06% revenue from public/donations (see Table 3) and the similar cluster from the new 296 received 85.21% revenue from the same source (the highest of the clusters). Further, Table 3 shows that service providers (Cluster 2) in the original 803 received 72.42% revenue from goods and services and the similar cluster from the new 296 charities received 73.43% revenue from goods and services (again, the highest of all the clusters), while trusts/grantors (Cluster 5) in the original 803 received 92.20% revenue from investment and the similar cluster from the new 296 received 92.64% from investment.

The same held true for expenditures in the confirmatory data set (of 296). Service providers (Cluster 2) in the original 803 expended 36.25% on services (see Table 4) and the similar cluster from the new 296 charities expended 34.95% on services. Further, Table 4 shows that 41.66% of trusts/grantors' (Cluster 5) expenditure in the original 803 was on grants and the similar cluster from the new 296 expended 42.60% on grants.

With respect to assets and liabilities, service providers (Cluster 2) and classic charities (Cluster 1) in the original 803 recorded 41.26% and 49.42% cash assets respectively (see Table 5) and the similar clusters from the new 296 charities recorded 41.41% and 37.45% in cash assets respectively. The mean for social services was almost identical; however, classic charities held slightly less in the simple random sample of 296 than the stratified sample of 803 charities. Further, Table 5 shows that in the original 803 infrastructure providers (Cluster 4) hold 65.81% of their assets in Property, Plant
and & Equipment (PP&E) and the similar cluster from the new 296 held 45.29% in PP&E. Finally, trusts/grantors (Cluster 5) in the original 803 held 67.69% in investments (see Table 5) and the similar cluster from the new 296 charities held 65.70% in investments.

This consistency in patterns of revenue, expenditure, assets and liabilities between the two different data sets suggest that this method of grouping charities is robust and reflects a repeatable pattern in New Zealand charities. Further analysis of the charities within each cluster was undertaken to estimate the percentages within the population of regulated organizations. We used the second sample of 296 charities (used to validate the clustering, as discussed in section 5.2), which was a simple random sample of regulated charities in New Zealand. The standard 95% confidence interval for a proportion was used and is shown in Table 6. This data is now discussed.

### 5.2.3 A schema for classifying organizations subject to public regulation

From the regulation theory literature reviewed, we expect that the types of charities that would benefit most from regulation and which government would be most interested in regulating would be those that purport to act in the public interest. Governments would be most interested to ensure that these charities are eligible for their exemptions from income tax and that the tax credits that donors can claim are worthwhile. Charities working in the public interest will be those that receive a high levels of public donations (and therefore arise from market failure, as argued by Rose-Ackerman, 1986); and/or charities that provide social services (as Weisbrod, 1988 argues, these arise to reduce government failure). These were identified by the cluster analysis as Cluster 1 (“Classic Charities”) and Cluster 2 (“Service Providers”).

Table 6: Stakeholder-driven regulation model

<table>
<thead>
<tr>
<th>Cluster</th>
<th>Main funder</th>
<th>Secondary funders</th>
<th>Type of regulation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Classic charity</td>
<td>34.1% + 5.4%</td>
<td>Donations</td>
<td>Publicly regulated due to majority of funding from donations.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Services, investments, members and rental.</td>
<td></td>
</tr>
<tr>
<td>2. Service provider</td>
<td>38.9% + 5.55%</td>
<td>Funders of goods and services</td>
<td>Publicly regulated due to government-funded services.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Donations, investments, members</td>
<td></td>
</tr>
<tr>
<td>3. Member organization</td>
<td>8.1% + 3.11%</td>
<td>Membership</td>
<td>Self-regulated by member-managers. (Differentiated)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Services, sponsors, investments and</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>donations</td>
<td></td>
</tr>
<tr>
<td>4. Infrastructure provider</td>
<td>3.7% + 2.15%</td>
<td>Rental</td>
<td>Self-regulated by trustees/management. (Differentiated)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Investments and donations</td>
<td></td>
</tr>
<tr>
<td>5. Trust/grantor</td>
<td>15.2% + 4.09%</td>
<td>Investments</td>
<td>Self-regulated by trustees /management. (Differentiated)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Donations and rental</td>
<td></td>
</tr>
</tbody>
</table>
As shown in Table 6, this research showed that Cluster 1 (“Classic Charities”) and Cluster 2 (“Service Providers”) total only between 67.94% and 78.06% of all registered (regulated) charities (73 ± 5.06%). On the other hand, the three other clusters (Cluster 3: “Member Organizations”; Cluster 4 “Infrastructure Providers”; Cluster 5: “Trusts/grantors”) receive low levels of revenue from public donations and public funding of goods and services. These “types” have arisen due to contract failure and/or to increase social capital (as hypothesized by Ben-Ner, 1986; Bryce, 2005). Their main resource providers are more concentrated than the general public and they are likely to be legally empowered to monitor these charities (Mayer & Wilson, 2010). It therefore appears that government regulation of these charity “types” is a duplication of resources. In addition, we found that the regulator’s tight operating budget, increasing donation rebates, and government funding into the sector are juxtaposed against a rising number of public complaints about charities, as well as regulator audits, suggest declining public trust and confidence. The New Zealand case is an example of the need to find cost efficiencies, so that the regulator can focus on improving charity accountability.

We noted earlier that differentiated regulation has been used as a policy tool in some industries. In electricity regulation, consumer-owners monitor the prices and quality of their own electricity distribution business in the manner described by Ben-Ner (1986). In that example, differentiated regulation has reduced the cost of monitoring as the regulator can fully audit and respond to complaints about a smaller number of organizations (those that meet its brief) and leave other (legally empowered) stakeholders to monitor the organizations which are not required to be fully regulated. It can be expected that the stakeholders of these other charities would provide monitoring in any case, but when regulatory resources are duplicated, these stakeholders receive false comfort from believing government also actively regulates these charities.

Differentiated regulation could be useful when members predominate in a charity and they also enjoy the goods and services it provides. These members are unlikely to need a regulator in order to access financial and other data from charities which they fund (these would be cluster 3: “Member Organizations”). When members fund and manage interdependent (mutual) nonprofit entities, they are able to demand financial reporting from these organizations (Hansmann, 1986). It has been argued that such stakeholder management will be of a higher quality than that provided by the regulator alone (Breen, 2013; Freeman, 1984). Further, if these stakeholders are unhappy with the charity’s management, members can exit by resigning and not paying their membership fees. As shown in Table 6, between 5% and 11.2% of registered charities are member organizations (8.1 ± 3.11%). In line with Hansmann (1986) and Ben-Ner (1986), we argue that the members should
already regulate these charities and that the rise of a public regulator has potentially reduced members’ effort with detrimental effects on public trust and confidence.

In respect of two other clusters (4: “Infrastructure Providers and 5: “Trusts/grantors”), it is also apparent that donors and funders of goods and services are not the prime resource providers. Government’s regulatory effort is likely to have sent the wrong signal to stakeholders of entities which do not arise from market or government failure. Infrastructure providers represent 0.35%-5.85% (3.7% ± 2.15%) of the population and the trusts/grantors are represent 10.91%-19.29% (15.2% ± 4.09%) of the population. They receive funds from rental and investments respectively and are managed in terms of their trust deeds. In respect of investment income, Kreander, Beattie and McPhail (2009) confirm that organizations with investment funds should be closely monitored by their boards. For infrastructure organizations, their boards and management should also monitor rental revenue. Combined with member organizations, infrastructure providers and trusts/grantors represent between 21.94% and 32.06% of the total population.

6. Conclusion

Public trust and confidence in charities has declined and yet significant resources continue to be committed to the sector. Regulatory effort and monitoring has been ineffective, in part due to limited resources. We recommend differentiated regulation and demonstrate its feasibility by analysis of data on registered charities in New Zealand to show that charities do fall into distinct types. We found that around 27 percent of the organizations do not receive significant funding from either donations nor charitable goods and services delivery. Around 8 percent of the organizations are member-based. and the remaining 19 percent of registrations - infrastructure providers and trusts/grantors - can be managed by trustees for a similar reason. These groups could be eliminated from the focus of the regulator and hence enable the regulator to focus its slim resources on the other 73% of charities that do require regulatory oversight.

The data analysed covers 95.96 percent of the total number of registered charities in New Zealand and present probably the biggest regulatory challenge due to their diversity. Their profile is similar to that in other countries, for example Canada (Phillips, 2013), England and Wales and Ireland (Breen, 2013) and the US (Mayer & Wilson, 2010). Hence, we are unaware of specific contextual factors that would make these New Zealand charities markedly different from their counterparts in other Anglo-American countries at least. Therefore, this analysis of disclosure-based regulation of charities generally could be applied by both older regulators (for example US, England and Wales) and newer regulators, such as the ACNC in Australia.
Refocusing regulatory effort to reflect differentiated regulation principles to reinstate the onus on members to monitor, could reduce charities’ compliance costs by reducing government monitoring of these charities. More importantly, this strategy would enable the regulator to re-focus its scarce resources and increase effort on those charities that receive a majority of their funds from donations and/or publicly-funded service provision. Following such a re-focus, the regulator would be better placed to achieve its aim to promote the public interest, and public trust and confidence in registered charities might increase.

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i Economic theories refer to nonprofit organisations in general, but this paper focuses on organisations defined in jurisdictions as charities, a subset of the nonprofit sector.

ii For example, ‘cream-skimming’ or servicing clients that present simple, profitable cases is a problem endemic in health care.

iii That is, government fails to deliver public or collective goods that match demand.

iv Nevertheless, this question of unfair competition is void if there are no for-profit participants (as occurs when market failure is present).

v Differentiated regulation may also be used to open a market (to reduce a cartel and therefore as the antithesis of entry restriction) and is often used in the telecommunication and electricity industries to encourage greater competition (Peitz, 2005). Here, an asymmetry between operators with significant market power and those without is recognised by forcing major market players to provide newcomers with access to a network at prices the regulator sets to increase access and competition (Peitz, 2005).

vi All of these charities were automatically donee organizations. The cap on the donor rebates was removed in 2008 thus increasing rebates to a maximum of the tax paid by the donor (the rebate being a third of the donation, no matter the taxpayer’s tax bracket).

vii Charities pay NZ$51.11 per annum if they file their annual statements and updates on line and NZ$75.67 if they send in a paper version of updates and annual accounts (amounts ex-Goods and Services Tax). Charities with income of less than NZ$10,000 pay no annual return fee.


ix The register included 21,156 organizations that had filed financial reports in November 2011, the date at which the register was accessed. Financial reports were progressively downloaded between November 2011 and January 2012.

x Johns Hopkins University lists 12 different sectoral groupings for nonprofit organizations: culture and recreation, education and research, health, social services, environment, development and housing, civil rights, advocacy and politics, grant-making, philanthropic intermediaries and volunteerism promotion, international, religion, business and professional associations, unions and “not elsewhere classified” (Salamon & Anheier, 1992a, 1992b). Charities select their sector on their annual filing. These groupings were not useful to test the hypothesis as they did not separate out revenue flows and activities.

xi These dollar ranges were chosen as they corresponded to proposed reporting requirements. The population of the ‘small’ (<$40,000) segment was 11,282 and the ‘medium’ (>40,000 and <2 million) was 9,019.

xii Each revenue category was expressed as a percentage of total revenue. Expenditures were expressed as a percentage of total expenditure and so on.
Cases:


References:


