Testimony
Before the Subcommittee on Oversight, Committee on Ways and Means, House of Representatives

NONPROFIT SECTOR
Increasing Numbers and Key Role in Delivering Federal Services

Statement of Stanley J. Czerwinski
Director, Strategic Issues
NONPROFIT SECTOR

Increasing Numbers and Key Role in Delivering Federal Services

Why GAO Did This Study
The nonprofit sector is an important means through which public services are delivered and national goals addressed. The federal government increasingly relies on networks, often involving nonprofits that address many issues—health care, education, and human services, for example. Because nonprofit organizations play a key role as partners with the federal government, there is a need to better understand the sector.

Highlights
Accountability Integrity Reliability

Why GAO Did This Study
The nonprofit sector is an important means through which public services are delivered and national goals addressed. The federal government increasingly relies on networks, often involving nonprofits that address many issues—health care, education, and human services, for example. Because nonprofit organizations play a key role as partners with the federal government, there is a need to better understand the sector.

This testimony (1) provides a picture of the nonprofit sector—its size, composition, and role in the economy; (2) discusses how and why the federal government partners with the sector; and (3) identifies issues related to the sector as a federal partner that need to be better understood.

What GAO Found
U.S. nonprofit organizations have a significant role both in the economy as a whole and as providers of services. While the majority of nonprofit organizations have relatively small operating budgets, together their impact is large. For example, researchers estimate that the sector’s spending in recent years was roughly 11 to 12 percent of the nation’s gross domestic product and, in 2002, the sector had over 9.6 million employees, about 9 percent of the civilian workforce. Further, the sector has grown; the number of charitable organizations reporting almost tripled over the last two decades.

The federal government increasingly partners with nonprofit organizations as they bring many strengths to these partnerships, such as flexibility to respond to needs and access to those needing services. These organizations receive significant funds from government sources to provide services. Researchers have attempted to quantify these funds. For example, one estimate is that the federal government spent about $317 billion on nonprofit organizations in fiscal year 2004. However, the lack of data makes measuring federal funds to nonprofit organizations difficult. Many funds come through indirect routes, such as through state and local government, adding to the difficulty of determining funding and measuring performance. Although IRS is generally responsible for overseeing the tax-exempt status of these organizations, there is less focus at the federal level on the comprehensive role of nonprofits in providing services using federal funds.

Our preliminary look at how the federal government interacts with the nonprofit sector indicates that several policy issues have emerged; examples follow.

- **Coordination and collaboration**—the increasing importance of collaboration between all levels of the government and nonprofit organizations.
- **Internal governance issues**—the need to strengthen internal governance of nonprofit organizations.
- **Capacity**—the need to improve smaller nonprofit organizations’ capacity to address weaknesses in finances, administration, and human capital.
- **Nonprofit sector data**—the need for improved data on the sector’s size, financial status, and funds from federal sources.
- **Administrative and reporting requirements**—the many requirements to be accountable, which while important and necessary, require information in different formats and with increasing complexity.
- **Fiscal challenges for nonprofits**—the instability of some nonprofits’ financial position.

At the request of the Congress, we are beginning work to examine these issues further.


To view the full product, including the scope and methodology, click on the link above. For more information, contact Stanley J. Czerwinski at (202) 512-6806 or CzerwinskiS@gao.gov.
Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to participate in today’s hearing to discuss our preliminary work and observations on the role the nonprofit sector plays in partnering with federal, state, and local governments to deliver programs and services. Although the sector is an important means through which many key national goals are addressed, its role can be nearly invisible to federal policy-setting decision makers when designing and implementing programs. Broadly stated, the federal government increasingly relies on large and complex networks of nonfederal actors to carry out initiatives. In recent years, most oversight of the sector has focused on its tax-exempt status. However, because the nonprofit sector plays a key role in delivering services funded by the federal government, there is also a need to better understand the sector as a partner on which the federal government relies.

The nonprofit sector is defined primarily by its tax-exempt status, a designation that occurs at both the federal and state levels of government. In addition, nonprofit organizations share certain other characteristics. First, they work to serve public purposes or the common goals of their members. Further, they can benefit from voluntary labor and are self-governing. In addition, they are not permitted to distribute profits to their members but must instead use them to further the organization’s charitable purpose. Beyond these commonalities, they have a diverse set of missions, and many of those missions are related to those of federal agencies. As a result, it is important to better understand the composition of the sector, its importance, and its strengths and challenges.

An estimated 1.8 million organizations were recognized as federal-tax-exempt organizations as of September 2006. Of these, about 60 percent (see fig. 1) are public charities or foundations that benefit the broad public interest, and are referred to as 501(c)(3) organizations. Our focus today is largely on charities, as they represent the majority of the sector. (See further clarification of key terms in app. I.)

---

1The tax-exempt sector is often referred to as the nonprofit sector.

As you know, the Internal Revenue Service (IRS) serves as the agency that generally oversees the nonprofit sector at the federal level. IRS focuses on whether organizations meet tax-exempt requirements and comply with federal laws, such as those governing the use of funds intended for a charitable purpose. It approves organizations for federal tax-exempt status and is the recipient of annual reporting of financial data on Forms 990, which are required from organizations with gross receipts over $25,000.³ In addition, a few other federal organizations, such as the Federal Trade Commission and the Department of Justice, provide oversight of nonprofit organizations in certain specialized areas. States also play an important role in the oversight of nonprofits, as they have interests and responsibilities in areas such as the legitimacy of charitable fundraising and whether a charity is meeting the charitable purpose for which it was created. In addition, the public plays a role in oversight through its ability to review key information on individual organizations, to the extent useful information is available.

³Churches are not required to file for tax-exempt status, nor to report annually.
My testimony today will point out some of the diversity and the range of characteristics present within the sector, along with some of the issues that arise as nonprofit organizations interact with the federal government. I would like to (1) provide a picture of the nonprofit sector—its size, composition, and role in the economy; (2) discuss how and why the federal government partners so extensively with the sector; and (3) identify issues that others have raised related to the sector as a federal partner that need to better understood.

My statement is based largely on some preliminary work we recently completed that focused broadly on the intersection of nonprofits and the federal government. We focused on trends in the use of federal funding and on identifying emerging issues in the nonprofit sector. We interviewed representatives from several large nonprofit member associations, research and advocacy organizations, academic researchers, foundation representatives, and nonprofit practitioners. We hosted two roundtable discussions with key researchers and practitioners in the nonprofit area. We also reviewed literature on the sector from academic centers, research institutes, foundations, and others to better understand sector trends and issues, and to identify additional experts for interviews. Our work included a review of our previous work related to nonprofits on a wide variety of topics, such as tax policy, human service programs, and executive compensation. Our work was performed in accordance with generally accepted government audit standards.

While the majority of nonprofits individually have relatively small operating budgets, as a whole, the nonprofit sector has a significant presence in the U.S. economy, according to researchers of the nonprofit sector. For example,

- In 2004, nonprofit organizations that submitted Forms 990 to IRS held an estimated $3 trillion in total assets and received $1.4 trillion in revenues.\(^4\)

---

During the period 1998 through 2002, spending reported by tax-exempt entities was roughly 11 to 12 percent of the nation’s gross domestic product.\(^5\)

The tax-exempt sector had over 9.6 million employees, about 9 percent of the civilian workforce in 2002.\(^6\)

Wages and salaries paid to nonprofit sector employees comprised 8.3 percent of those paid in the U.S. in 2004.\(^7\)

In addition to representing a significant portion of the U.S. economy, the sector is growing. Data indicate that from May 2000 to May 2006, the number of registered public charities has grown over 30 percent from about 646,000 to about 851,000, although organizations that have gone out of existence may be included in those numbers.\(^8\) Other data also suggest growth in the sector. As shown in figure 2, the number of 501(c)(3) organizations completing the Form 990 has almost tripled over the last two decades (from 1986 to 2006) from about 148,000 to about 427,000.


\(^6\)GAO-05-561T, p. 10.


Experts have identified several possible contributing reasons for this increase:

- a shift in recent decades away from government providing most services directly;
- the expansion of service-related industries in the U.S., of which many nonprofits are a part;
- deinstitutionalization during the 1960s and 1970s that eliminated large, public care facilities in favor of smaller, community-based organizations, often operated by nonprofit entities; and
- the trend in devolution in certain policy areas such as welfare, which contributed to a lessening role of the federal government and more localized control in the hands of state, local, and nonprofit organizations.


Note: Public charities and private foundations are both 501(c)(3) entities. Organizations that have annual gross receipts not normally in excess of $25,000, churches, and certain other exempt organizations are not required to file the annual information return.
Nonprofit organizations are found in a wide variety of policy areas such as health care, education, and human services, and include many prominent and highly visible community institutions, such as hospitals, museums, job training centers, and churches. (See a list of categories in app. 2.) These organizations also represent a diverse range of sizes. According to the Independent Sector, 73 percent had annual budgets of less than $500,000 in 2004 and only 4 percent had budgets exceeding $10 million.\(^9\)

Much of the data on the sector come from the IRS Form 990, but those data have limitations. For example, returned Forms 990 are sometimes incomplete or inaccurate and are not consistently followed up on, and some nonprofit organizations required to submit Forms 990 do not do so. In addition, for certain types of funding, the Form 990 does not distinguish between government and private sources of support. It also does not break out the sources of government grants by federal, state, or local level. We have pointed out in the past the importance of requiring information in a more timely and user-friendly way on IRS Forms 990.\(^10\)

Federal Government Increasingly Partnering with Nonprofit Organizations

Nonprofit organizations bring many strengths to their partnerships with the federal government. Their breadth and diversity allow the sector to address the specific needs of communities and of individuals. Researchers commenting on the advantages of nonprofits point out the provision of benefits in the public interest, often with greater flexibility and access than can be achieved by the public sector. Nonprofits often bring an in-depth understanding of a particular geographic area or special population and have access to underserved populations.

Nonprofit organizations play a large and increasing role in delivering services traditionally provided by the government, according to researchers. Their research indicates that nonprofit organizations receive significant funds from government sources and that over time these funds have increased. As we previously noted, data are limited but researchers have attempted to analyze data from various sources and identify trends in federal funding to nonprofits. Their work offers a glimpse into the

---

\(^9\)The Independent Sector describes itself as a nonprofit, nonpartisan coalition of about 600 national public charities, foundations, and corporate philanthropy programs, collectively representing tens of thousands of charitable groups in every state.

\(^10\)GAO-05-561T.
magnitude of federal funds going to nonprofits, but does not provide a comprehensive analysis of the various funding streams. For example:

- Researchers have reported that the federal government provided about $115 billion directly to nonprofits in fiscal year 2001, the majority of which hospitals received through the Medicare program. Indirect federal funds through state and local governments to nonprofits were an estimated $84 billion, totaling about $199 billion, or about 15 percent of federal payments and grants.\footnote{Woods Bowman and Marion R. Fremont-Smith, “Nonprofits and State and Local Governments,” \textit{Nonprofits and Government}, 2nd Edition, eds. E. Boris and C. Steurle (Washington, D.C.: The Urban Institute Press, 2006), pp. 191-194.}


- Researchers estimate that federal support to nonprofit organizations increased more than 230 percent from fiscal year 1980 to fiscal year 2004 in adjusted dollars.\footnote{Alan Abramson, Lester Salamon, and C. Eugene Steurle, “Federal Spending and Tax Policies: Their Implications for the Nonprofit Sector.”}

Federal funds reach nonprofit organizations through many paths (see fig. 3). Some flow directly from federal agencies to nonprofit organizations, such as research grants to universities. Some funds flow to states as grants, whose funds may flow to nonprofit organizations, or may flow to local governments that compensate nonprofit organizations for services with those funds. Also, some federal funds move to nonprofits on the basis of individuals' decisions, that is, from federal programs to nonprofits selected by the consumer, such as for health care. In addition to direct and indirect federal funds, nonprofit organizations benefit from being tax-exempt and also from other tax policies, such as donors' ability to deduct contributions on their taxes.
The current federal oversight of nonprofits is focused on organizations' tax-exempt status and on specific programs. However, there is less focus on understanding the overall role of nonprofits as implementers of national and federal initiatives, and how to best ensure that nonprofits have the support they need. As we spoke with researchers and practitioners, several issues emerged as needing attention in order to ensure the strength of this important partner to the federal government. We have looked at specific issues involving nonprofit organizations over the years, but our past work was largely related to specific programs. We heard several common issues while taking this more comprehensive look at nonprofit organizations’ interaction with the federal government (see fig. 4).
Coordination and collaboration—One theme that surfaced in our preliminary research was the importance and value of coordination and collaboration between nonprofit organizations and government at all levels. As we pointed out in our work on 21st century challenges, the government relies increasingly on new networks and partnerships to achieve critical results and develop public policy, often including multiple federal agencies, non- or quasi-government organizations, for-profit and nonprofit contractors, and state and local governments. A complex network of governmental and nongovernmental entities shape the actual outcomes achieved, whether it be through formal partnerships in grant programs or through independent actions of each addressing common problems. For example, our research on disaster relief efforts following September 11 and Hurricanes Rita and Katrina highlighted the role of nonprofits in providing assistance and the importance of communication and coordination of services with government entities. We pointed out that the scope and complexity of the September 11 attacks presented challenges to charities in their attempts to provide seamless social services for surviving family members and others in need of aid. With


regards to the response to Hurricanes Katrina and Rita, we noted that charities could improve coordination among charities and the Federal Emergency Management Agency.\textsuperscript{16}

We believe that many of the key practices that help enhance and sustain collaboration among federal agencies can be helpful between government and nonprofit organizations, such as when both parties collaborate to

- define and articulate a common outcome;
- establish mutually reinforcing or joint strategies;
- identify and address needs by leveraging resources;
- agree upon roles and responsibilities;
- establish compatible policies, procedures, and other means to operate across boundaries;
- develop mechanisms to monitor, evaluate, and report the results of collaborative efforts;
- reinforce accountability for collaborative efforts through plans and reports; and
- reinforce individual accountability for collaborative efforts through performance management systems.\textsuperscript{17}

\textbf{Internal governance issues}—A second theme that surfaced in our preliminary research was the need to strengthen governance of nonprofit organizations, a point made by the sector itself as well as by others. At the organization level, a sound governance structure can establish the set of checks and balances that help steer an entity toward result-oriented outcomes consistent with their purposes while also guarding against abuses. Concerns about accountability and transparency of nonprofit organizations have grown in recent years. In 2004 and 2005, the Senate Finance Committee held hearings to look more closely at practices that are illegal or not in keeping with standards typical of the charitable sector, and released a discussion draft of possible solutions. In October 2004, the Independent Sector convened a panel, whose report made several


recommendations to address concerns.\textsuperscript{18} The panel continues to focus on self-regulation as a way to address these concerns, although there are mixed opinions on the potential success of self-regulation. In addition, several efforts are under way within the sector to raise awareness of ways to improve internal governance of nonprofits, including associations focusing on providing training or consulting, and national certification processes.\textsuperscript{19}

**Capacity**—Another area to which researchers suggest attention should be paid is improving the capacity that smaller nonprofit organizations have to address weaknesses in finances, administration, and human capital. Many nonprofits struggling to accomplish their mission on limited budgets lack the resources that could allow them to better manage their finances and strengthen their infrastructure. In addition, particularly in smaller nonprofit organizations, the strengths of board members may be in addressing their organization’s mission, and they may lack legal and financial knowledge or the skills necessary to oversee a nonprofit entity. One specific area identified as needing attention is the development of human capital, as these organizations need to address a complex set of issues, such as competition for service workers, leadership succession, and staff turnover. One promising change is the increase in graduate programs offering a concentration in nonprofit management from 17 in 1990 to 97 in 2001.\textsuperscript{20} While there has not been a comprehensive effort by the federal government to improve the capacity of nonprofit organizations, several federal programs provide capacity-building grant funding and technical assistance to nonprofits. Providing assistance to improve capacity may be one area where the federal government could employ a more strategic approach.

**Nonprofit sector data** – As I mentioned earlier, there is a lack of sufficient knowledge on a key federal government partner and its role.


\textsuperscript{19}For example, BoardSource, National Council of Nonprofit Associations, and the Alliance for Nonprofit Management all focus to some extent on strengthening internal governance of nonprofits. An example of a national certification process is one established by the Standards for Excellence Institute.

Researchers point out that without better data on the nonprofit sector as a whole, appropriate and timely policy decisions regarding nonprofits cannot be made. Some actions under way may improve information on tax-exempt organizations. Beginning in 2008, small tax-exempt organizations that previously were not required to file Form 990 returns, with some exceptions (such as churches) will be required to file a shorter notification form electronically. In July 2007, IRS began mailing educational letters to over 650,000 small tax-exempt organizations that may be required to submit the notice. Further, IRS is seeking comments on a redesigned Form 990, intended to provide a realistic picture of organizations and their operations and to accurately reflect an organization’s operations and use of assets. In addition to the Form 990, other sources of data have also been used to better understand the sector, such as Bureau of Labor Statistics employment data, but continued access to that data has been a problem. In addition, the funds to perform the analysis generally come from the nonprofit sector, and are not consistently available.

**Administrative and reporting requirements**—Practitioners and researchers alike addressed the difficulty that nonprofit organizations, particularly smaller entities, have in responding to the administrative and reporting requirements of their diverse funders. While funders need accountability, the diverse requirements of different funders make reporting a time-consuming and resource-intensive task. Experts report that both government and foundations have increasing expectations that nonprofits conduct performance measurement, but meeting the expectations, given the size of grants and the evaluation capabilities of the staff, can be difficult. One researcher said that practitioners report performance evaluation as one of the biggest challenges they face, given their capacity issues.

**Fiscal challenges for nonprofits**—Nonprofit organizations, particularly smaller entities, often operate with limited budgets and have limited capital. As one researcher noted, the logic of the business world is “upended” with nonprofit organizations. Researchers and practitioners

---

21The form is entitled “Form 990-N Electronic Notice (e-Postcard) for Tax-Exempt Organizations Not Required to File Form 990 or 990-EZ.”

22We have not evaluated the redesigned Form 990.

have pointed out that nonprofit organizations often have inadequate funds to invest in management infrastructure and that government and private foundations have not provided them adequate overhead funding to, for example, pay salaries to attract employees with needed skills or upgrade systems that would maximize efficiency. Funders—federal, state and local governments, foundations, and private donors—are willing to pay varying amounts toward overhead, resulting in nonprofit organizations needing to sometimes turn to other sources to cover their overhead costs. We believe this is an area in which more data are needed to fully understand the implications of reimbursement for overhead charges.

Virtually every American interacts with the nonprofit sector in his or her daily life through a broad range of concerns and activities such as health care, education, human services, job training, religion, and cultural pursuits. In addition, federal, state, and local governments rely on nonprofit organizations as key partners in implementing programs and providing services to the public. Given the way the sector is woven into the basic fabric of our society, it is essential we maintain and cultivate its inherent strength and vitality and have accurate and reliable data on the overall size and funding flows to the sector. Keys to a healthy nonprofit sector include strengthening governance, enhancing capacity, ensuring financial viability, and improving data quality without overly burdening the sector with unnecessary or duplicative reporting and administrative requirements. At the request of the Congress, we are beginning work to examine these issues further.

Mr. Chairman, this concludes my prepared statement. I would be happy to respond to any questions you or other Members of the Committee may have.

For further information on this testimony, please contact Stanley Czerwinski at (202) 512-6806. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this testimony. Individuals making key contributions to this testimony include David Bobruff, Tom James, Heddi Nieuwsma, Carol Patey, and Tom Short.
Appendix I: Key Terms Related to Nonprofit Status

- **Tax-exempt organization**: An entity determined to be exempt from federal income taxes.
- **Nonprofit status**: A state-law concept, in which approved entities may be eligible for exemption from sales, property, and state income taxes.
- **Section 501(c)(3) organization**: An organization that has an exempt purpose such as serving the poor; advancing religious, educational, and scientific endeavors; protecting human rights; and addressing various other social problems.
- **IRS Form 990**: An IRS information return that many tax-exempt entities, meeting certain requirements, must file annually.
Appendix II: Types of Programs and Services in the Nonprofit Sector

The IRS uses the National Taxonomy of Exempt Entities system to classify tax-exempt organizations by industry subsector. When an organization is initially approved as tax-exempt, it is classified into one of these 10 broad categories of tax-exempt entities:

- **Arts, culture, and humanities**
  Museums, performing arts centers, media and communications, historical societies
- **Education**
  Elementary and secondary schools, colleges and universities, libraries and educational services
- **Environment and animals**
  Botanical gardens, natural resources conservation and protection
- **Health**
  Hospitals, mental health services, medical research, home health care, substance abuse treatment
- **Human services**
  Homeless shelters, youth development, job training, crime prevention, soup kitchens, recreation and sports
- **International, foreign affairs**
  Human rights, international cultural exchange, international development, peace and security, foreign affairs
- **Public, societal benefit**
  Foundations, civil rights, credits unions, economic development, public transportation, veterans’ organizations
- **Religion-related**
  Religion-related organizations, interfaith coalitions, religious media and communications
- **Mutual membership/benefit**
  Insurance providers, pension and retirement funds, fraternal societies, cemeteries
- **Unknown, unclassified**
GAO’s Mission

The Government Accountability Office, the audit, evaluation and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO’s commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO’s Web site (www.gao.gov). Each weekday, GAO posts newly released reports, testimony, and correspondence on its Web site. To have GAO e-mail you a list of newly posted products every afternoon, go to www.gao.gov and select “Subscribe to Updates.”

Order by Mail or Phone

The first copy of each printed report is free. Additional copies are $2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. Government Accountability Office
441 G Street NW, Room LM
Washington, D.C. 20548

To order by Phone: Voice: (202) 512-6000
TDD: (202) 512-2537
Fax: (202) 512-6061

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

E-mail: fraudnet@gao.gov
Automated answering system: (800) 424-5454 or (202) 512-7470

Congressional Relations

Gloria Jarmon, Managing Director, JarmonG@gao.gov (202) 512-4400
U.S. Government Accountability Office, 441 G Street NW, Room 7125
Washington, D.C. 20548

Public Affairs

Paul Anderson, Managing Director, AndersonP1@gao.gov (202) 512-4800
U.S. Government Accountability Office, 441 G Street NW, Room 7149
Washington, D.C. 20548