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# The Changing Place of the 501(c)(3)

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Last year AEA Consulting developed the working paper "Critical Issues Facing the Arts in California" for the James Irvine Foundation. Since its release, the report has generated extensive conversations and responses, both within and beyond California. GIA invited Adrian Ellis, principal of AEA Consulting, to offer further thoughts on the current state of the arts in the United States. Here, Ellis focuses on the characteristics of 501(c)(3) nonprofit organizations and the disadvantages they may face in the context of rapidly changing markets.

# The Changing Place of the 501(c)(3)

*Adrian Ellis*

The reflections in this essay are prompted by having knocked around in the nonprofit cultural sector in the United Kingdom and the United States for twenty years as a line manager, a foundation officer, and latterly as a consultant. The last twenty years have been a period of almost unimaginable change: in the threats and opportunities presented by geopolitics, in our relationship to technology and the environment, and in the economic structures that sustain us. But our cultural organizations, superficially at least, look very similar: a bit more weary inside, some new facades outside, but there are many of the same entities, often the same faces, and the same agendas.

This may be because creativity and the canon of culture change more slowly than these other areas of human endeavor. But it may be that it is because nonprofit cultural organizations are unhealthily insulated – and as a result isolated – from these wider changes.

Definitions of cultural activity have broadened in parallel with our understanding of the relationships between individual creativity, self-expression, and society or community. In policy or funding contexts, the term is typically taken to mean the work of individual artists and makers, unincorporated associations (such as the Social Aid and Pleasure Societies of New Orleans), commercial entities (such as film and new-media producers and distributors), public sector organizations, and, of course, incorporated not-for-profit organizations. The definitions of culture used by policy analysts are not usually as broad as those used by anthropologists, who tend to include mores and customs that are attributable to broad social and ethnic groups rather than activities attributable to individuals or organizations. The cultural policy community has usually found anthropological definitions of culture inoperably broad.

Responsible, strategic funding by government and the philanthropic community requires an understanding of the impact of their financial and other interventions; of the internal dynamics of these groups of actors within the cultural community; and of the complex, interdependent relationships that exist between them. However, notwithstanding that we acknowledge this complex reality in principle, in practice the focus of attention and inquiry of both academics and funding agencies tends to remain the incorporated not-for-profit organization. In this essay, I wish to explore two arguments about shortcomings in this preferred vehicle for cultural activity. Unaddressed, I think these shortcomings are likely to render the nonprofit cultural organization increasingly out of synch with the wider community it is designed to serve, and the wider cultural ecology in which it operates. The shortcomings are, I think, perceived to some degree by the funding community as they observe cultural nonprofits that have an increasingly weak grip on the imagination and wallets of the communities in which they operate, but their causes and effects are less well understood.

So, to the shortcomings…First, as private-sector capital markets have become more efficient and liquid, they have become a major catalyst for social and cultural (in the anthropological sense), as well as economic, change, manifest for example in the changing ethnic and linguistic composition of our cities, or the massive changes in income and wealth distribution, which has been broadly progressive between societies but regressive within them.

The explosive growth of international capital markets, harnessed to advances in technology, is the principal driver behind the accelerating globalization that, for good or ill, defines our age. Changes in demographics, in the tastes and assumptions of audiences and visitors, and in their expectations of technology and service are all affecting the "consumer" side of the equation – the audiences of, visitors to, and participants in the activities of museums, galleries, live theater, opera, and dance. But responses to those changes are not driven by a capital market or a shareholder class seeking to overcome the challenges and exploit the opportunities that these changes present.

Nonprofit cultural organizations can and do have continued access to capital from trusts, foundations, and individual philanthropists for extended periods of time in circumstances where a competitive capital market would have choked off and reallocated funds. This is because of the power of bonds of loyalty, habit, and, yes, inertia.

The scale and sophistication of the development function in arts organization; relative salary position of development staff within the sector; and the percentage of board and executive director time devoted to securing capital attest to the high returns that accrue to well-employed and well-directed rhetoric in a sector lacking or unpersuaded by quantitative data on performance. In parallel, nonprofit start-ups find access to capital difficult because the same fragmented, custom-bound, and opaque funding system discriminates against new entrants. This prevents anything more than incremental adjustment in the allocation of resources, even in non-incremental times.

Second, the hierarchical nature of the nonprofit organization, with its non-executive board structure and aversion to extensive delegation of financial authority, is appropriate for organizations that enjoy the fiscal privileges afforded 501(c)(3) status. The 501(c)(3) conventionally – almost invariably – has a board that is drawn from a range of actual or assumed stakeholders in its activities together with people who have the time and/or access to the financial resources required to fund the organization. This group does not, by definition, have a detailed operational knowledge of the organization but has ultimate responsibility for decisions made concerning and by the organization. It deals with this dilemma by circumscribing, through bylaws and codes of conduct, the managerial autonomy of those who have day-to-day but not legal responsibility.

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As with the absence of a developed capital market, however, this structure makes adaptive responses to rapid social and economic change problematic. Nonprofits appear to have organizational attributes or tendencies that are actually the antithesis of what is considered to be best practice for the creative organization, specifically flat organizational structures; heavy investment in organizational learning and its support systems (IT, professional development, the HR function); and, in management jargon, "tight-loose" systems that allow heavily delegated decision-making within a clear framework of values and agreed goals. Again, there are systemic reasons for this tendency related not to 501(c)(3) status per se but to the checks and balances that this status requires to safeguard it from abuse.

These two features of the nonprofit cultural organization are not new. They represent latent weaknesses in the form that are more likely to become manifest in periods of rapid change, such as those we are witnessing, than in periods of stability. However, as the 501(c)(3) is a central component of a vibrant cultural ecology, some thought should, I suggest, be given to ways in which it might be developed as an organizational form to address these shortcomings, as well as to how funding decisions can encourage that development. This agenda is or should be a central one for the funding community.

## The Implications of a Lack of a Shareholder Class

501(c)(3) is a provision of the United States Internal Revenue Code 501(c), which lists twenty-eight types of nonprofit organizations exempt from some federal income taxes. (We do not hear much about most of them.) Many states also reference Section 501(c) for definitions of organizations exempt from state taxation. 501(c)(3) exemptions apply to corporations and any community chest, fund, or foundation organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or "to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals." Culture fits somewhere under that rubric.

The benefits of tax exemption are, of course, only available to organizations that serve a public purpose, and that public purpose is in part protected by the absence, in nonprofit organizations, of a shareholder class, and by its replacement by a board tasked with fiduciary responsibilities that at their core revolve around the protection of the organization's public purpose or mission. This means that the market for capital works in a fundamentally different way in the nonprofit and for-profit sectors. In the for-profit sector, those with capital seek to maximize their rate of return on that capital through strategic investment decisions, and those enterprises that do not secure an adequate rate of return – that is, the uncompetitive ones – are starved of capital and subject to what is euphemistically called "rationalization" – restructuring, closure, or merger. The capital markets, and the investors whose private financial interests they serve, constantly work to balance supply and demand because that is what maximizes their return on investment. The experiences of the "Rust Belt" and "Sun Belt" states over the past thirty years are examples of this powerful process.

There are two important consequences to the absence of this market mechanism in the nonprofit sectors. The first is that accessing capital is much more challenging, and requires a range of techniques (fundraising) and instruments (tax incentives to donors) to substitute for the absence of developed capital markets. Capital, when secured, is less fungible, tending to be tied by the donor and funders to specific purposes – e.g., educational programming, new commissions, or a new building – rather than to overall organizational performance. Many of the characteristics of the sector stem from the ways in which capital is secured – and the fact that certain types of capital are more easily secured than others. In the cultural sector, the fact that it is easier to raise funding for bricks and mortar than for endowment and other balance-sheet items, or for investment in people and technology, has a permanent and disfiguring impact on the sector, if the ostensible purposes or missions of cultural organizations are taken in good faith as their *raison d'être.*

We are all still fumbling with the tools to measure the impact of investment in the sector. Economic impact has a superficial appeal, but few cultural organizations embrace it as a central cultural purpose, and the methodologies by which it is measured are considered suspect by most economists who do not directly benefit from the work. The measurement of cultural and social impact is expensive and more difficult to calibrate, although there are continuous advances in the field and we are right to just keep plugging away at it.

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However, as and when measured (whatever the methodology) against the one criterion that should inform all allocative decision-making – the extent to which an investment has furthered the core mission of the organization funded more effectively than any alternative deployment of the funds – much investment in the sector falls short, because of the lack of fungibility of the investment funds. Arts leaders invest in what they are able to secure funds to invest in just as much what they feel their organizations need investment in. Form follows funding and the evolution of cultural activity as a policy instrument (tourism, urban regeneration, inward investment, etc., etc.) has exacerbated the contingent nature of funding.

The second impact of the absence of a shareholder class is perhaps more significant. The absence of a capital market means that systemic imbalances between supply of and demand for cultural activities can exist for long periods of time with no mechanism for adjustment. One of the effects of increasingly efficient capital markets, nationally and globally, is the rapid movement of capital flows toward investment opportunities and away from less-profitable applications. This is highly disruptive socially and politically, and the traumatic and accelerating impact of the deregulation of capital markets is perhaps *the* defining story of our age – the story of accelerating changes in global, national, and regional wealth distribution; in demographics; and in the clash of values between the advocates for and beneficiaries of globalization and its opponents and victims.

Nonprofit cultural organizations, by virtue of their funding structures, are significantly insulated from the *direct* impact of these forces. They experience them in their retail markets – in the changing composition and interests of their audiences, for example, and in the competition for those audiences' time and attention. But their responsiveness to those changes can be, and often is, muted and delayed because the consequences of a muted, delayed response are not as immediately felt as they would be if their financial performance were being tracked continuously and acted upon swiftly by investors and their agents and advisors, as is the fate of public companies in late capitalism.

Inefficiencies in the allocation of capital can, in the absence of a competitive market, remain unaddressed for long periods of time, and inertia, together with political and sentimental appeals to institutional history, can allow organizations to continue in existence long after the demise of a vital mission or purpose. Most funders have experienced the "un-dead" arts organization: heavy on infrastructure, resource-hungry, politically well-connected, entitlement-oriented, and blustering about rather than demonstrating its continued relevance in a changing world. The effectiveness of such tactics prevents the reallocation of available resources to other, more vital, cultural purposes. As capital markets have become increasingly efficient in the past two decades in the private sector, the contrast between the pace of structural change in the private and nonprofit sectors has increased.

I am not making a moral point here, nor advocating the demise of the 501(c)(3). I am simply trying to articulate some implications of its form. The reasons for the absence of a shareholder class in 501(c)(3) organizations are compelling, and directly related to the need to protect the primacy of public purpose. But we need to give more careful and dispassionate thought to the implications – that, all other things being equal, the allocation of resources to the more politically adept, the more argumentative, the more ingenious and, above all, to those who have a claim on the *status quo* – is likely to favor a nonprofit cultural sector more and more out of synch with the rapidly changing society that it exists to serve.

The more rapidly society changes, the more out of synch the 501(c)(3) organization is likely to be, and the greater the effort required to ensure that there is congruence between the nonprofit cultural sector and the communities in which it operates. Furthermore, individual boards of individual cultural organizations have neither the incentive nor the ability to effect the systemic reallocation of resources among art forms or among communities that are better served to those that are underserved. The funding community represents, *de facto*, the proxy for capital market for nonprofits but often feels constrained and self-conscious in its articulation of those responsibilities because it has not addressed its responsibilities from this perspective. The response is a sluggish and politicized response to the profound social change that we are witnessing in the United States and globally. If the funding community is to fulfill its critical role, it probably needs to look at its responsibilities from a more systemic and radical perspective than it currently chooses, or at least has chosen, to adopt. Decisions need to be informed by an understanding of the place of the 501(c)(3) in the wider cultural ecology, as well as the place of an individual 501(c)(3) in the universe of nonprofits.

The philanthropic version of the Hippocratic Oath "First, Do No Harm" is a powerful and wise injunction. But it needs to be qualified by an understanding that funding only incremental change in an environment experiencing non-incremental changes may itself be harmful. Left to its own devices, the sector will necessarily be slower and more arbitrary in its response to change than it would if there were a more developed and liquid capital market fuelling its investment decisions.

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## The Dynamics of a Non-executive Board

A second attribute stemming directly from the provisions of Section 501(c) is that the organizations that have evolved to satisfy its requirements tend to have non-executive (that is, in effect, unremunerated) boards, thereby ensuring that those legally responsible for the governance of the organization do not have a financial interest in the organization's business. The advantages of this convention are obvious, but the disadvantages are no less so. The energies absorbed in attracting, inducting, organizing and maintaining a voluntary board are an abiding preoccupation of the sector. The vast self-help literature it has generated is well-meaning and sensible (and highly repetitive), but the basic task on which it meditates is not simply Sisyphean (a good category of task about which to publish books) but increasingly challenging.

As the fiduciary responsibilities of boards are spotlit by isolated (I believe) but nevertheless spectacular and therefore well-publicized breaches; as the requirements of fundraising and community representation pull in diametrically different directions; and as the civic perspective that informs board service appears to wane, the cumulative impact is to create a weakness at the center of the model that absorbs disproportionate time and emotional resources.

But even when boards function well, they inevitably create a form of apartheid within organizations, with a social or financial gulf between staff and board that is difficult to bridge authentically. This sense of hierarchy is inevitably reinforced by the often highly codified and circumscribed protocols surrounding the delegation of financial and related decision-making that is generated by the need to meet high standards of accountability and transparency. But this "rule-driven" approach is often difficult to square with the sort of fast, entrepreneurial, occasionally instinctive decision-making that is required for effective leadership in a complex operating environment. The more complex and fast-changing the operating environment, the greater the tension between the demands of accountability and those of informed risk-taking. Capital projects, for example, often require rapid decisions involving calculated risk as market opportunities occur, for example, around real estate acquisition or the signing of construction contracts; investment in technology often involves similarly uncomfortable dilemmas.

A third systemic tendency of the nonprofit model is underinvestment in professional development and human resources. The tendency can be overcome by strong and committed leadership, but the pressures are easy to understand: organizational success does not generate a surplus that you can reinvest, and programmatic expansion stretches rather than deepens the infrastructure required to support it. Sustaining organizational capacity, and attracting and retaining a skilled, agile workforce in a highly competitive and mobile labor market ranks second only to board development as the saloon bar topic of nonprofit leaders.

These tendencies – hierarchical organizational forms with limited effective delegation and difficulty in securing the resources to attract and retain a skilled workforce – are just that: tendencies, not inevitabilities. Strong, committed, informed leadership can go some way to mitigating them. But cumulatively, and unaddressed, they can create curiously conservative and inward-facing organizational cultures, far from the archetypical creative industry model characterized in the management literature pioneered by writers like Max Du Pre and John Kao.

The organizational cost may be necessary but it is a high one: the adaptive, innovative behavior needed in the tough environment in which nonprofit cultural organizations find themselves is less likely to be present than in flatter, more decentralized, and more knowledge-oriented forms of organization. Over time, the nonprofit cultural sector has found it increasingly difficult to attract, retain, and engage the best minds of its generation in exactly the same way and for the same reasons that large corporations have lost out to smaller, more flexible private-sector entities.

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We live, in many ways, in a golden age, with respect to creation and creativity *and* with respect to wide access to aesthetic experiences of the highest standard. The financial barriers to entry for creative cultural participation and engagement have never been lower. But the business and organizational models that have traditionally supported these activities seem precarious and in flux.

Views are divided as to the long-term merits and implications of this trend. Dystopians like Andrew Keen, author of the recent polemic *The Cult of the Amateur*, argue that the democratization of the means of production and the lack of respect afforded the expert and the canon will have a fundamentally adverse effect on cultural standards; utopians like Chris Anderson, author of *The Long Tail*, or scholar Lawrence Lessig believe we are on the threshold of a golden age of participation, in which the democratization of the means of production and the lack of deference toward the canon may leave behind those who are unprepared to accept the demand for active involvement, but will generate a large and willing following for those who can respond. A revolution driven by advances in technology and its pricing; in distribution systems; in search engines; and in mass communication is bolstered by and reinforces challenges to curatorial and directorial authority and expertise.

However, many nonprofits across art forms like opera, classical music, and throughout the visual arts have sought to underscore rather than bridge the separation of professional from the amateur or community participation. In so doing, they have cut themselves off from this wider trend. The worlds respectively of *creation and creativity* on the one hand and of *access to cultural experiences* (the domain of the 501(c)(3)) on the other have become increasingly bifurcated to the detriment of the vitality of the latter.

The 501(c)(3) has been and will remain near or at the center of the cultural sector, but there is no reason why philanthropic capital should be overwhelmingly channeled toward it rather than toward other vehicles for cultural creation and participation. Neither the private for-profit, nor the public, nor the unincorporated entity can fulfill the organizational role that the nonprofit does. But the nonprofit has shortcomings that are thrown into high relief in periods of rapid change such as those we are experiencing. An acknowledgement of those shortcomings will facilitate the adaptive behaviors and tough decisions about resource allocation that are required and that the long-term vitality of the sector mandates.

The market should not be the measure of all things and I am not suggesting that it should be. In the current voracious phase of "late capitalism" it is probably more important than it has ever been to place alternative values alongside the market. I am suggesting that when we do assert those values, and create or run organizations to promote and sustain them, we have to do so with unsentimental clarity about what those values are, and be prepared to judge performance and allocate resources in accordance with those values, and that the faster changing the wider context, the more radical will be the decisions informed by those values.

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