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## The Role of Nonprofit Enterprise

Henry B. Hansmann<sup>†</sup>

Private nonprofit institutions account for a sizable and growing share of our nation's economic activity.<sup>1</sup> The sectors in which these institutions are most common—education, research, health care, the media, and the arts—are vital elements in the modern economy. More-

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<sup>†</sup> Assistant Professor of Law and Public Policy, University of Pennsylvania.

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1. At present there are no accurate and comprehensive published data on the size and growth of the nonprofit sector. Some estimates, however, can be made from the National Income Accounts. See U.S. DEP'T OF COMMERCE, BUREAU OF ECONOMIC ANALYSIS, THE NATIONAL INCOME AND PRODUCT ACCOUNTS OF THE UNITED STATES, 1929-74, at 16-19, 88-89, 326, 336 (1977). These accounts include income derived from nonprofit institutions within the total for a category denominated "households and institutions," which also contains such household-generated income as compensation of domestic servants. The portion of this total that is attributable to nonprofit institutions can be estimated by subtracting from it the figure reported in the accounts for compensation paid by private households. Since the figure for households and institutions itself is derived as a residual—that is, is not built up separately from primary data—the accuracy of the resulting estimate is difficult to judge; nevertheless, it appears to be the best estimate obtainable.

The data suggest that the nonprofit sector accounted for roughly 2.8% of national income in 1974. More dramatic than the absolute size of the sector has been its growth. It has more than doubled as a percentage of national income since 1929, when the figure was 1.2%. Furthermore, the growth of the sector has been particularly rapid in recent years: the share of national income it represents increased by roughly 33% in the period 1960-1974. The growth of the sector in absolute terms, of course, has been even more dramatic.

Because nonprofits are concentrated in the labor-intensive service industries, the share

over, these are sectors that present particularly pressing and difficult problems of public policy. The existing literature in law and economics, however, has largely overlooked nonprofit institutions; while we are reasonably well supplied with positive and normative perspectives on both profit-seeking and governmental organizations, to date there has been extraordinarily little effort to understand the role of nonprofits.<sup>2</sup>

This lack of understanding is reflected in the substantial confusion that characterizes policymaking concerning nonprofits. Nonprofit corporation law is poorly developed and varies in significant respects from one state to the next. Even the Model Nonprofit Corporation Act exhibits uncertainty about such basic issues as the purposes for which nonprofit corporations may be formed.<sup>3</sup> Large classes of nonprofits receive special treatment in almost all areas in which federal legislation impinges upon them significantly, including corporate income taxation,<sup>4</sup> Social Security,<sup>5</sup> unemployment insurance,<sup>6</sup> the minimum wage,<sup>7</sup> securities regulation,<sup>8</sup> bankruptcy,<sup>9</sup> antitrust,<sup>10</sup> unfair competition,<sup>11</sup>

of total direct employment accounted for by nonprofits is even larger than its contribution to GNP, amounting to 5.9% in 1973. See Ginzberg, *The Pluralistic Economy of the U.S.*, SCIENTIFIC AMERICAN, Dec. 1976, at 25, 26.

A considerable fraction of the current size and recent growth of the nonprofit sector derives from the preponderance of nonprofit institutions in two important areas, hospital care and private education, particularly post-secondary education. See [1964] & [1973] NATIONAL CENTER FOR EDUCATION STATISTICS, PROJECTIONS OF EDUCATION STATISTICS; Cooper, Worthington, & Piro, *National Health Expenditures, 1929-1973*, 37 SOC. SECURITY BULL. 3, 3-19 (February 1974).

For further observations on the increasing importance of nonprofit organizations, see V. FUCHS, *THE SERVICE ECONOMY* (1968); E. GINZBERG, D. HIESTAND, & B. REUBENS, *THE PLURALISTIC ECONOMY* (1965); Ginzberg, *supra*.

2. But see B. WEISBROD, *THE VOLUNTARY NONPROFIT SECTOR* (1977); Nelson & Krashinsky, *Two Major Issues of Public Policy: Public Subsidy and Organization of Supply*, in PUBLIC POLICY FOR DAY CARE OF YOUNG CHILDREN 47 (R. Nelson & D. Young eds. 1973), discussed in notes 34 & 46 *infra*.

3. The authors of the Model Act, evidently unable to agree as to whether or how the permissible purposes should be limited, simply offer two alternative versions of the purposes clause. ALL-ABA MODEL NONPROFIT CORPORATION ACT § 4, alternative § 4 (1964). The authors neither explain the difference in meaning between the two versions nor offer a coherent discussion of the considerations involved in choosing between them. See *id.* at viii-ix; note 24 *infra*.

4. I.R.C. § 501(c)(3).

5. 42 U.S.C. § 410(a)(8)(B) (1976).

6. I.R.C. §§ 3306(b)(5)(A), (c)(8).

7. 29 U.S.C. § 203(r) (1976); 29 C.F.R. § 779.214 (1979).

8. 15 U.S.C. § 77c(a)(4) (1976).

9. 11 U.S.C.A. § 303(a) (West Supp. 1979).

10. See *Marjorie Webster Junior College v. Middle States Ass'n of Colleges and Secondary Schools*, 423 F.2d 650 (D.C. Cir.), *cert. denied*, 400 U.S. 965 (1970) (applying relaxed antitrust standards to organizations with "noncommercial" objectives).

11. 15 U.S.C.A. §§ 44, 45 (West Supp. 1979); see *Community Blood Bank of Kansas City Area, Inc. v. FTC*, 405 F.2d 1011 (8th Cir. 1969).

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copyright,<sup>12</sup> and postal rates.<sup>13</sup> Yet the principles on which such special treatment is based are nowhere clearly formulated. Similarly, there continues to be debate concerning the action of the National Labor Relations Board in shifting radically, over the past decade, from a policy of excluding nonprofits entirely from coverage under federal labor law to a policy of including them under the law on the same terms as profit-seeking enterprise.<sup>14</sup>

In this Article, I seek to develop a broad perspective on the economic role that nonprofit organizations perform. My purpose is both to fill some of the gaps in our positive theories of institutions and to provide a basis for informed policymaking. The Article discusses the entire spectrum of nonprofit organizations, though it focuses primarily upon nonprofit corporations that produce goods and services. This class of institutions, sometimes referred to as "operating" nonprofits, includes, for example, colleges, hospitals, day care centers, nursing homes, research institutes, publications, symphony orchestras, social clubs, trade associations, labor unions, churches, and organizations for the relief of the needy and distressed.<sup>15</sup> My concern is with private nonprofit organizations, not with governmental enterprises; one of the objectives of this Article is, in fact, to explore the factors that distinguish the role of private nonprofits from that of government.

### I. The Essential Characteristics of Nonprofit Enterprise

Before examining the purposes served by nonprofit organizations, it is necessary to have a clear image of their essential structural features.

12. 17 U.S.C. §§ 110, 111(a)(4), 112(b), 118(d)(3) (1976).

13. 39 U.S.C.A. § 3626 (West Supp. 1979).

14. The shift began in 1970, *see* Cornell University, 183 N.L.R.B. 329 (1970), and was essentially completed by 1976, *see* St. Aloysius Home, 224 N.L.R.B. 1344 (1976). In addition to such general issues as these, there exist a host of current problems involving particular sectors. For example:

Should licenses be granted to private nursing homes only if they are nonprofit? Such a policy has been proposed in New York. *See* TEMPORARY STATE COMM'N ON LIVING COSTS AND THE ECONOMY, REPORT ON NURSING HOMES AND HEALTH RELATED FACILITIES IN NEW YORK STATE 13 (1975).

Should nonprofit organizations in the performing arts receive government subsidies? The federal government began giving substantial direct subsidies to the performing arts only recently, through the National Endowment for the Arts, and there is pressure for it to raise its level of support to considerably higher levels. *See* Brustein, *Can the Show Go On?* N.Y. TIMES MAGAZINE, July 10, 1977, at 8.

Can a private educational institution be denied accreditation solely on the grounds that it is proprietary rather than nonprofit? *See* Marjorie Webster Junior College v. Middle States Ass'n of Colleges and Secondary Schools, 432 F.2d 650 (D.C. Cir.), *cert. denied*, 400 U.S. 965 (1970) (upholding denial of accreditation to proprietary college).

15. I shall devote correspondingly little attention to foundations, which for the most part are simply philanthropic intermediaries that produce no goods and services of their own. *See* note 41 *infra*.

### A. *What Makes an Organization Nonprofit?*

A nonprofit organization is, in essence, an organization that is barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees. By "net earnings" I mean here pure profits—that is, earnings in excess of the amount needed to pay for services rendered to the organization; in general, a nonprofit is free to pay reasonable compensation to any person for labor or capital that he provides, whether or not that person exercises some control over the organization. It should be noted that a nonprofit organization is not barred from earning a profit. Many nonprofits in fact consistently show an annual accounting surplus.<sup>16</sup> It is only the distribution of the profits that is prohibited.<sup>17</sup> Net earnings, if any, must be retained and devoted in their entirety to financing further production of the services that the organization was formed to provide. Since a good deal of the discussion that follows will focus upon this prohibition on the distribution of profits, it will be helpful to have a term for it; I shall call it the "nondistribution constraint."

Most nonprofits of any significance are incorporated. For these organizations, the nondistribution constraint is imposed, either explicitly or implicitly, as a condition under which the organization receives its corporate charter.<sup>18</sup> Thus a nonprofit corporation is distinguished from a for-profit (or "business") corporation primarily by the absence of stock or other indicia of ownership that give their owners a simultaneous share in both profits and control.

In the corporation law of some states, the nondistribution constraint is accompanied or replaced by a simple statement to the effect that the

16. In 1969, for example, by one accounting, the nonprofit hospital sector as a whole experienced a net profit of \$400 million, representing 3.5% of total revenue and a 3.6% return on plant assets. See K. DAVIS, NET INCOME OF HOSPITALS 11, 18 (U.S. Dep't of HEW, Soc. Security Ad., Office of Research & Statistics, Staff Paper No. 6 (1970)). As another example, the nonprofit Educational Testing Service has recently shown annual net earnings in the area of \$1,000,000. Wall St. J., Feb. 28, 1978, at 1, col. 1.

17. See *American Jersey Cattle Club v. Glander*, 152 Ohio St. 506, 510, 90 N.E.2d 433, 435 (1950). Some state nonprofit corporation statutes explicitly allow nonprofits to earn profits as long as they are not distributed to the corporations' members, directors, or officers. See *Indiana General Not-For-Profit Corporation Act*, IND. CODE ANN. § 23-7-1.1-4(c) (Burns 1972).

Recently there has been some support for replacing or supplementing the term "nonprofit" with the phrase "not-for-profit." See Note, *New York's Not-For-Profit Corporation Law*, 47 N.Y.U. L. REV. 761, 774 (1972). Presumably one reason for this is that the former phrase misleadingly suggests that the organizations involved are distinguished by the fact that they make no profits. But then the phrase "not-for-profit," aside from being more cumbersome, suffers from some ambiguities of its own. In what follows I shall stay with the shorter and more commonplace label.

18. *E.g.*, ALL-ABA MODEL NONPROFIT CORPORATION ACT §§ 2(c), 26 (1964).

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organization must not be formed or operated for the purpose of pecuniary gain.<sup>19</sup> Often such a condition as applied is equivalent to the nondistribution constraint. Occasionally, however, it is interpreted more restrictively to mean that an organization may not be incorporated as a nonprofit even if it is intended to assist in the pursuit of pecuniary gain in a more indirect manner.<sup>20</sup>

Another restriction that was until recently quite common,<sup>21</sup> and that still appears in the statutes of some states, is that an organization can incorporate as a nonprofit only if it is formed to serve one or more of a limited set of purposes.<sup>22</sup> Today such explicit limitations are the exception rather than the rule. Many states now permit a nonprofit corporation to be formed "for any lawful purpose,"<sup>23</sup> which, like the similar language that is today nearly universal in business corporation statutes, means that it may be formed to engage in any activity that is not criminal—subject, of course, to the nondistribution constraint.<sup>24</sup> There continues to be strong debate about the wisdom of restricting the purposes for which nonprofit corporations may be formed.<sup>25</sup> This Article will, I hope, help to clarify the issues in that debate. For the moment, however, we need only remember that this restriction, like the restrictive interpretation sometimes taken concerning the pursuit

19. *E.g.*, 15 PA. CONS. STAT. ANN. § 7316(4) (Purdon Supp. 1978) (articles of incorporation must contain "statement that the corporation is one which does not contemplate pecuniary gain or profit, incidental or otherwise").

20. For example, trade associations have sometimes been denied the right to incorporate as nonprofits on the grounds that their purpose is to improve business conditions for their members, and that therefore the motive behind their formation is pecuniary gain. *See, e.g.*, Application of Pittsburgh Chevrolet Dealers' Ass'n, 296 Pa. 431, 146 A. 26 (1929); *In re* Incorporation of Automatic Phonograph Owners Ass'n, 45 Pa. D. & C. 551 (Phila. County C.P. 1942). This interpretation, I believe, misconceives the purpose served by nonprofit organizations, as should become clearer in the pages to follow.

21. *See generally* Note, *Permissible Purposes for Nonprofit Corporations*, 51 COLUM. L. REV. 889 (1951) (surveying law as of 1951).

22. For example, the Massachusetts statute provides an explicit and presumably exhaustive list of the purposes that such an organization can serve, stating that they may be formed for, among other things, "establishing and maintaining libraries; . . . promoting temperance or morality in the commonwealth; . . . fostering, encouraging or engaging in athletic exercises or yachting"; or, more broadly, "any civic, educational, charitable, benevolent or religious purpose." MASS. ANN. LAWS ch. 180, § 4 (Michie/Law. Co-op 1977).

23. *See, e.g.*, MONT. REV. CODES ANN. § 35-2-106 (1979).

24. Many other states follow the suggested provision in the Model Act that permits incorporation "for any lawful purpose or purposes, including, without being limited to, any one or more of the following purposes: charitable; . . . religious; social; . . . agricultural; . . . trade association; . . ." ALI-ABA MODEL NONPROFIT CORPORATION ACT § 4 (1964). It might appear that such a clause is equivalent to the simple phrase "for any lawful purpose." The rather cryptic comments on this issue offered by the authors of the Model Act, however, suggest that they intended the former clause to be more restrictive. *See* note 3 *supra*.

25. *See* Oleck, *Proprietary Mentality and the New Non-Profit Corporation Laws*, 20 CLEV. ST. L. REV. 145 (1971).

of pecuniary gain,<sup>26</sup> may have had some impact on the historical pattern of nonprofit development.

In most other respects, the nonprofit corporation statutes closely parallel the statutes that provide for business corporations. In fact, they are, if anything, even more permissive. Thus a nonprofit corporation may have a membership that, like the shareholders in a business corporation, is entitled to select the board of directors through elections held at regular intervals. But the statutes typically do not make this a requirement, so that the board of directors may, alternatively, simply be made an autonomous, self-perpetuating body.<sup>27</sup>

Sometimes nonprofit organizations are formed as charitable trusts without being incorporated, although for operating nonprofits this approach is uncommon in the United States.<sup>28</sup> In such cases, control over the organization lies with the trustees, and the nondistribution constraint is imposed by the law of trusts, which prohibits trustees from taking from the trust anything beyond reasonable compensation for services rendered.<sup>29</sup>

## B. *A Categorization of Nonprofit Organizations*

The flexibility of the corporation statutes permits nonprofit organizations to assume a wide variety of forms. Consequently, for the sake of simplifying exposition and analysis, it will help us to develop a basic subcategorization of nonprofits according to the manner in which they are financed and controlled.

### 1. *Financing: Donative Versus Commercial Nonprofits*

Nonprofits that receive most or all of their income in the form of grants or donations I shall call "donative" nonprofits. Organizations for the relief of the needy, such as the Salvation Army, the American Red Cross, and CARE, are perhaps the most obvious examples. Those nonprofits that, on the other hand, receive the bulk of their income from prices charged for their services I shall call "commercial" non-

26. See note 19 *supra*.

27. See ALI-ABA MODEL NONPROFIT CORPORATION ACT §§ 11, 18 (1964).

28. See M. FREMONT-SMITH, FOUNDATIONS AND GOVERNMENT 40 (1965).

29. See 3 A. SCOTT, LAW OF TRUSTS § 242 (3d ed. 1967).

Unincorporated associations can sometimes also be appropriately labeled "nonprofit." Their status is problematic, however, for there is no well-developed body of statutory or case law dealing with them, and in particular, no simple mechanism whereby the nondistribution constraint can be imposed and enforced. See H. OLECK, NON-PROFIT CORPORATIONS, ORGANIZATIONS, AND ASSOCIATIONS 61-63 (3d ed. 1974). Because of this, and because incorporation is relatively simple, it is uncommon to encounter substantial organizations that are operated as unincorporated nonprofit associations.

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profits. Many nursing homes, most hospitals, and the American Automobile Association would clearly fall within this latter category.

Of course, not all nonprofits fit neatly into one or the other of these two categories. For example, most universities rely heavily upon donations as well as upon income from the sale of services—*i.e.*, tuition—and thus lie somewhere between the two. Consequently, donative and commercial nonprofits should be considered polar or ideal types rather than mutually exclusive and exhaustive categories.

In this Article I shall use the word “patrons” to refer to those persons who constitute the ultimate source of a nonprofit’s income. Thus, in the case of a donative nonprofit, by “patrons” I mean the organization’s donors, while in the case of commercial nonprofits I use the term to refer to the organization’s customers; when the organization receives income from both customers and donors, the term comprises both.

### 2. *Control: Mutual Versus Entrepreneurial Nonprofits*

Nonprofits that are controlled by their patrons I shall call “mutual” nonprofits. Country clubs provide an example: generally their directors are elected by the membership, which comprises the organization’s customers. Common Cause, the citizens’ lobby, presents another example: the board of directors of that organization ultimately is selected by the membership, which consists of all individuals who donate at least fifteen dollars annually to the organization.<sup>30</sup> On the other hand, nonprofits that are largely free from the exercise of formal control by their patrons I shall term “entrepreneurial” nonprofits. Such organizations are usually controlled by a self-perpetuating board of directors. Most hospitals and nursing homes, for example, belong within this latter category. Again, the two categories are really the ends of a continuum. For example, the board of trustees of some universities is structured so that roughly half is elected by the alumni—which con-

30. It should be recognized that there are many nonprofits that have “members” but that are most appropriately characterized as entrepreneurial rather than mutual nonprofits. For example, many nonprofits designate their patrons as members but offer them no control over the organization. In such organizations one is a member in precisely the same sense that one becomes a member of the distinctly proprietary Book-of-the-Month Club. Other nonprofits, in turn, are controlled by a group of persons who are designated members, but who are not the organization’s patrons. For example, control over local United Way organizations resides in its member agencies, which are the service organizations that receive the funds that United Way collects from individual patrons; the patrons themselves have no direct voice in United Way’s affairs. In fact, the term “member,” as it is used in the nonprofit corporation statutes and by nonprofit organizations themselves, often is applied so broadly as to have little definite meaning. For example, the Model Act gives the incorporators of a nonprofit complete freedom in establishing criteria for membership and in determining what rights (including voting rights), if any, the members are to have. See ALL-ABA MODEL NONPROFIT CORPORATION ACT §§ 8, 15, 34, 40, 45 (1964).

stitutes the bulk of past customers and present donors—while the other half is self-perpetuating.

It is important to recognize that, while the organizations that I have termed “mutual” nonprofits may bear some resemblance to cooperatives, they are by no means the same thing. Cooperatives are generally formed under state cooperative corporation statutes that are quite distinct from both the nonprofit corporation statutes and the business corporation statutes. Cooperative corporation statutes typically permit a cooperative’s net earnings to be distributed to its patrons or investors, who may in turn exercise control over the organization. Thus, cooperatives are not subject to the nondistribution constraint that is the defining characteristic of nonprofit organizations.<sup>31</sup>

3. *The Four Resulting Categories*

The intersection of the preceding divisions in terms of finance and control produces four categories of nonprofits: (1) donative mutual; (2) donative entrepreneurial; (3) commercial mutual; and (4) commercial entrepreneurial. The following diagram displays some typical examples of these four types of organization.

	mutual	entrepreneurial
donative	<p>Common Cause National Audubon Society political clubs</p>	<p>CARE March of Dimes art museums</p>
commercial	<p>American Automobile Association Consumers Union* country clubs</p>	<p>National Geographic Society** Educational Testing Service community hospitals nursing homes</p>

\* Publisher of *Consumer Reports*

\*\* Publisher of *National Geographic*

31. See pp. 879-90 *infra* (distinguishing role and structure of nonprofits and cooperatives).

Mutual nonprofits should also be distinguished from entities such as mutual insurance companies and mutual savings and loan associations, which generally are structured essentially as cooperatives.



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With these bits of nomenclature at our service, we can now turn to more substantive matters.

### II. Toward a General Theory of the Role of Nonprofit Enterprise

Undoubtedly many factors help explain why nonprofit institutions have proliferated in some areas of activity and not in others. Some of these factors are peculiar to particular types of nonprofits and will be considered below when we focus on individual sectors. There is, however, a rather general answer to the question, what makes a given activity more suitable to nonprofit than to for-profit organization?<sup>32</sup>

Economic theory tells us that, when certain conditions are satisfied, profit-seeking firms will supply goods and services at the quantity and price that represent maximum social efficiency. Among the most important of these conditions<sup>33</sup> is that consumers can, without undue cost or effort, (a) make a reasonably accurate comparison of the products and prices of different firms before any purchase is made, (b) reach a clear agreement with the chosen firm concerning the goods or services that the firm is to provide and the price to be paid, and (c) determine subsequently whether the firm complied with the resulting agreement and obtain redress if it did not.

In many cases—most notably with standardized industrial goods and farm produce—these requirements are reasonably well satisfied. Yet occasionally, due either to the circumstances under which the product is purchased and consumed or to the nature of the product itself, consumers may be incapable of accurately evaluating the goods promised or delivered. As a consequence, they will find it difficult to locate the best bargain in the first place or to enforce their bargain once made. In such circumstances, market competition may well provide insufficient discipline for a profit-seeking producer; the producer will have

32. The way I am approaching this question may appear a bit backward from a historical perspective. At least where corporations are concerned, nonprofits long antedate their for-profit counterparts, which are in fact relative latecomers on the organizational scene. Thus, while the modern American university can trace its ancestry directly to the chartering of the University of Oxford in the twelfth century, and ecclesiastical corporations such as monasteries go back even further, the first charters for profit-seeking corporations were not issued until nearly half a millennium later. See J. DAVIS, *CORPORATIONS* (1961) (surveying early development of corporate form in Anglo-American law). Viewed historically, then, we might well be tempted to ask why it was that large profit-seeking organizations arose. Yet today we are confronted with a well-articulated rationale for organizing economic activity along profit-seeking lines, and it is the nonprofits that seem to call for explanation. That explanation, I believe, can in large part be discovered by considering some of the limitations of the for-profit form.

33. Other, more familiar conditions are, for example, the absence of monopoly or collusive behavior among producers or purchasers.

the capacity to charge excessive prices for inferior goods. As a consequence, consumer welfare may suffer considerably.

In situations of this type, consumers might be considerably better off if they deal with nonprofit producers rather than with for-profit producers. The nonprofit producer, like its for-profit counterpart, has the capacity to raise prices and cut quality in such cases without much fear of customer reprisal; however, it lacks the incentive to do so because those in charge are barred from taking home any resulting profits. In other words, the advantage of a nonprofit producer is that the discipline of the market is supplemented by the additional protection given the consumer by another, broader "contract," the organization's legal commitment to devote its entire earnings to the production of services. As a result of this institutional constraint, it is less imperative for the consumer either to shop around first or to enforce rigorously the contract he makes.<sup>34</sup>

Of course, one would expect that when the profit motive is eliminated a price is paid in terms of incentives. For example, nonprofit firms might be expected to be slower in meeting increased demand and to be less efficient in their use of inputs than for-profit firms. In addition, in spite of the limitations imposed upon them, nonprofits may succeed in distributing some of their net earnings through inflated salaries, various perquisites granted to employees, and other forms of excess payments.<sup>35</sup> However, in situations in which the consumer is in a poor position to judge the services he is receiving, any approach to organizing production is likely to be a question of "second best." Moreover, it is plausible that the discipline of the market is in many cases sufficiently weak so that the efficiency losses to be expected from an industry of for-profit producers are considerably greater than those to be expected

34. Similar arguments have been advanced before with respect to particular services. For example, several authors have argued that, because hospital services are beyond the capacity of individual patients to judge effectively, nonprofit hospitals are preferable to profit-seeking hospitals, which might exploit the patient's ignorance and helplessness. See A. SOMERS, HOSPITAL REGULATION: THE DILEMMA OF PUBLIC POLICY 200-01 (1969); ARROW, *Uncertainty and the Welfare Economics of Medical Care*, 53 AM. ECON. REV. 941 (1963); Titmuss, *Ethics and Economics of Medical Care*, in R. TITMUS, COMMITMENT TO WELFARE 247, 254-55 (1968); Note, *The Role of Prepaid Group Practice in Relieving the Medical Care Crisis*, 84 HARV. L. REV. 887, 981 n.179, 995 (1971). Interestingly, hospital care is one of the areas of nonprofit activity in which this theory appears weakest. See pp. 862-72 *infra*. Such a theory also has been offered for children's day care. See Nelson & Krashinsky, *supra* note 2.

None of these discussions explains, however, why nonprofit institutions provide the consumer with greater protection. Nor do they explore the connection between the role of nonprofits in such areas as hospital care and child care and the role they play in other areas such as the performing arts and relief of the poor.

35. See pp. 873-75 *infra*.

from nonprofit producers. In sum, I am suggesting that nonprofit enterprise is a reasonable response to a particular kind of “market failure,” specifically the inability to police producers by ordinary contractual devices, which I shall call “contract failure.”<sup>36</sup>

If this line of reasoning at first seems a bit foreign, it is probably due in large part to the economic terminology in which it has been couched. In essence, it is saying nothing more than that we can view all nonprofits in much the same way that we have always viewed charitable trusts—that is, as fiduciaries. The only novel element is that in the case of many nonprofits—notably the ones that I have labeled “commercial”—the donors and the beneficiaries are one and the same group.

There are, to be sure, some isolated cases in which the nonprofit form has been adopted for reasons other than contract failure; social clubs, as I shall discuss later, provide the most important example. In general, however, contract failure is the essential factor in the role of nonprofit enterprise.

It follows from these basic notions that the corporate charter serves a rather different function in nonprofit organizations than it does in for-profit organizations. In the case of the business corporation, the charter, and the case law that has grown up around it, protect the interests of the corporation’s shareholders from interference by those parties—generally corporate management and other shareholders—who exercise direct control over the organization. In the case of the nonprofit corporation, on the other hand, the purpose of the charter is primarily to protect the interests of the organization’s *patrons* from those who control the corporation. For this fundamental reason, the corporate law that has been developed for business corporations, and particularly that which concerns the fiduciary obligations of corporate management, often provides a poor model for nonprofit corporation law. This fact has not always been appreciated.<sup>37</sup>

### III. Applications of the Theory

Contract failure occurs in a number of different forms and contexts. Some of the most common and most interesting of these contexts will be discussed here, in order to clarify the notion of contract failure and

36. For a discussion of some other forms of market failure, see Polinsky, *Economic Analysis as a Potentially Defective Product: A Buyer’s Guide to Posner’s Economic Analysis of Law*, 87 HARV. L. REV. 1655, 1665-69 (1974).

37. See ALI-ABA MODEL NONPROFIT CORPORATION ACT vii-viii (1964) (noting authors’ decision to follow Model Business Corporation Act as closely as possible).

to shed some light on the economic problems peculiar to some important industries in which nonprofits play a significant role.

In some instances, the circumstances that give rise to contract failure are simple and reasonably obvious. This is the case, for example, with institutions such as redistributive philanthropies and with institutions that provide complex personal services.<sup>38</sup> In other instances, the problems of contract failure that give rise to nonprofits are embedded in, or are the product of, various peculiar market conditions. This is the case with institutions in which contract failure is bound up with problems of public goods, price discrimination, and imperfect loan markets. In considering these latter institutions, it will be necessary to examine in some detail the full complex of factors that give rise to the need for nonprofit organizations.

#### A. *Separation Between the Purchaser and the Recipient of the Service*

Donative nonprofits provide the simplest and clearest applications of the contract-failure theory outlined in the preceding section. Of the various types of donative nonprofits, it is the most traditional of charities—namely those organizations that provide relief for the needy—that appear to be the easiest to understand.

Consider, for example, CARE, which obtains much of its funding from personal contributions. These contributions finance a relatively simple service, namely shipping and distributing foodstuffs and other supplies to needy individuals overseas.<sup>39</sup> Why is this service provided by a nonprofit organization rather than a for-profit one? That is, why do we not have profit-seeking firms that make essentially the same kind of offer that CARE does—that in return for payment to them of ten dollars, say, they will ship and distribute a given quantity of fortified milk to hungry children in India?<sup>40</sup> Shipment and distribution of food, after all, is an activity commonly performed by for-profit firms. If you rely on a for-profit food distributor to provide the food you feed to your

38. See pp. 862-72 *infra*.

39. See CARE, 32<sup>D</sup> ANNUAL REPORT (1978). The food that is shipped generally has been provided free of charge to the organization by the United States government Food-for-Peace program. The rationale for such government support of private nonprofits is explored in S. Rose-Ackerman, *Government Grants and Philanthropy* (1979) (unpublished manuscript) (on file with *Yale Law Journal*).

40. In its solicitations, CARE has always been quite explicit about just what a contribution "buys"; a recent appeal states, "\$5 serves 100 children a daily bowl of nourishing porridge for a week. \$10 gives 2,000 children each a glass of fortified milk. \$25 provides wheat flour for 3,000 nutritious biscuits in a school feeding program." CARE, *Promotional Brochure* (on file with *Yale Law Journal*).

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own children, why should you not also turn to a for-profit firm to provide the food you purchase for children overseas?

The answer, it appears, derives in large part from the fact that the individuals who receive the supplies distributed by CARE have no connection with the individuals who pay for them. Because of this separation between the purchasers and the recipients of the service, the purchasers are in a poor position to determine whether the service they paid for was in fact ever performed, much less performed adequately. If CARE were organized for profit, it would have a strong incentive to skimp on the services it promises, or even to neglect to perform them entirely, and, instead, to divert most or all of its revenues directly to its owners. After all, few of its customers could ever be expected to travel to India or Africa to see if the food they paid for was in fact ever delivered, much less delivered as, when, and where specified. The situation is quite different, of course, when an individual buys food for his own children. In that case, it is perfectly easy for him to rely on a for-profit grocer; he can check for himself whether he is getting his money's worth.

Thus, for a service of the type that CARE provides, it stands to reason that an individual would prefer to deal with a nonprofit firm, because in that case he has the additional protection provided by the nondistribution constraint; he needs an organization that he can trust, and the nonprofit, because of the legal constraints under which it must operate, is likely to serve that function better than its for-profit counterpart.

This does not mean, of course, that a nonprofit supplier is necessary or even appropriate in all situations in which one person subsidizes another's consumption. Indeed, such subsidies are often thoroughly compatible with for-profit enterprise. Thus, if goods rather than services are involved, the donor often has the option of simply taking delivery of the goods himself, thus ensuring that the producer has performed adequately, and then sending them personally to the donee—the procedure followed with most ordinary personal gifts. Further, in some cases, there are few problems with having a for-profit producer make delivery directly to the donee. For example, profit-seeking florist shops commonly arrange to have flower arrangements delivered all over the country as gifts. Because the arrangements involved are standardized and can be selected by picture, and because the donor is likely to hear from the recipient whether, and how well, the service was performed, there is only limited opportunity for abuse on the part of the florists.

Still another common approach to charity that utilizes for-profit producers involves subsidizing demand—that is, consumers—rather than supply. Redeemable coupons, such as food stamps or housing vouchers, are examples of a subsidy on the demand side. Gift certificates are a private counterpart to these government subsidy schemes. In situations in which demand-side subsidies are employed, the vigilance necessary to discipline for-profit producers comes from the donee rather than from the donor. It is only when the donor cannot contact the intended beneficiary of his gift directly, but instead must rely upon the producer of the subsidized service to act as the sole intermediary, that contract failure becomes a serious problem and a nonprofit producer seems necessary.<sup>41</sup>

### B. *Public Goods*

The concept of contract failure also helps to explain the prevalence of nonprofits as private-market producers of what economists term “public goods.” Public goods, in the language of economics, are goods or services that exhibit two particular attributes: first, it costs no more to provide the good to many persons than it does to provide it to one person, because one person’s enjoyment of the good does not interfere with the ability of others to enjoy it at the same time; and second, once the good has been provided to one person there is no way to prevent others from consuming it as well.<sup>42</sup> Hamburgers are clearly “private goods,” since they satisfy neither criterion: if I eat a hamburger you cannot eat it too—that is, hamburgers for two cost twice as much as hamburgers for one—and it is relatively easy for me to keep you from eating my hamburger. Air pollution control is commonly cited as an example of a public good; it costs as much to clean up the air for one citizen of Los Angeles as it does to clean it up for the whole city, and once the air has been cleaned up it is hard to prevent any individual from enjoying it.

If a public good is to be provided at the optimal level, and in the most efficient fashion, each individual should contribute toward its production a sum equal to the value he places upon it.<sup>43</sup> However,

41. Similar logic explains the nonprofit character of private foundations. If a wealthy individual wishes to turn over part of his fortune to a relatively autonomous organization that will itself choose the ultimate recipients of his largesse, he obviously will want to impose some form of nondistribution constraint upon that organization.

42. See R. MUSGRAVE & P. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 49-80 (2d ed. 1976).

43. To be more precise, each individual should contribute an amount that reflects his *marginal* valuation of the good or service.

individuals have an incentive to contribute little or nothing toward the cost of producing such a good for two reasons: first, the individual's contribution is likely to be so small in proportion to the total that it will not appreciably affect the amount of the good that is provided, and second, the individual will in any case be able to enjoy the amounts of the good that are financed by the contributions of others. Thus, there is little relationship between the size of an individual's contribution and the amount of the good that he enjoys. Assuming all individuals follow this logic and become "free riders," then little or none of the good will be supplied, even though collective demand for the good is in fact quite high. Thus, economists generally have concluded that the private market is an inefficient means of providing public goods, and have looked to alternatives such as public financing as a better approach.<sup>44</sup>

In fact, however, the free-rider psychology is far from universal; in many situations people *are* willing to contribute toward the production of public goods.<sup>45</sup> And what is important for our purposes—though it has generally been overlooked in the existing literature on public goods—is that even in these cases profit-seeking firms probably will constitute an unworkable means of providing public goods. Contract failure is likely to be a problem if consumers seek to purchase public goods from profit-seeking producers, and hence nonprofits are likely to be more suitable suppliers.<sup>46</sup>

### 1. *Contract Failure in a Public Goods Context*

Consider, for example, a listener-supported radio station of the type that now exists in many of the nation's larger cities. These stations carry no advertising, so that they may provide programming both uninterrupted by commercials and free of pressure from sponsors. They rely for most of their income upon direct contributions solicited from their listeners by over-the-air appeals.

Such stations are providing the listening audience a public good. It is no more costly to make the radio signal available to all individuals

44. See R. MUSGRAVE & P. MUSGRAVE, *supra* note 42, at 55-56.

45. I shall make little effort to explore here the factors that incline people to provide voluntary support for public goods. See p. 897 *infra*.

46. One economist has argued that nonprofit firms arise generally as private-market providers of public goods. See B. WEISBROD, *supra* note 2. Weisbrod does not, however, explain why the nonprofit form is more suitable in this area than the for-profit form. Moreover, although I agree that the provision of public goods is a significant role for nonprofits, I do not feel that it has the overall importance that Weisbrod assigns to it; rather, I see public goods simply as a special case of the more general contract failure theory developed in Part II. See pp. 843-45 *supra*.

living within a given radius of the broadcasting station than it is to provide the signal to one individual within that radius. Furthermore, with present technology, it is infeasible to bar an individual within the broadcast area from tuning in and listening until he makes a payment to the radio station. It is, in fact, precisely these characteristics of the service that have led commercial radio stations to forsake any effort to collect payment for their programming from listeners; instead, they have adopted the technique of selling their audience to advertisers. However, this expedient changes the nature of the service and the incentives of the broadcaster in a way that many listeners find unpleasant. The listener-sponsored radio stations, in order to avoid such a result, carry no advertising and seek to "sell" their programs directly to the listeners by soliciting voluntary payments from them. Interestingly, in many large cities such stations have succeeded, by exhorting their listeners a bit, in overcoming the free-rider problem sufficiently to keep in business.

This is, then, a situation in which enough people are willing to contribute voluntarily so that provision of a public good is economically viable on a nongovernmental basis.<sup>47</sup> But the private organizations that provide this public good are all nonprofit. Why are there not some listener-supported for-profit radio stations as well? Silly as the question may seem, it is instructive to be precise about the answer.

Imagine that such a for-profit station were to be formed, and that it sought voluntary contributions from its listeners to cover its costs—including a reasonable return on the owners' investment. Could it count on as high a level of voluntary payments as its nonprofit counterpart would receive? Undoubtedly it could not. The reason is simply that contributors would have little or no assurance that their payments to a for-profit station were actually needed to pay for the service they received. A for-profit station would have every incentive to solicit payments far in excess of the total needed to pay for its broadcasts, and simply to distribute the difference to the owners as profits. With a nonprofit station, on the other hand, the listener has some assurance that all of his payment will in fact be used to pay for the broadcasts.

The difference between the radio station and the CARE example discussed above is that with the former the contributor is also the ultimate recipient of the organization's services. Thus the problem

47. Many nonprofit radio stations now receive some financial support from the federal government through the Corporation for Public Broadcasting. However, a number of stations, such as those in the Pacifica group, arose long before any governmental support was available. Even today, public subsidies are only a small portion of the income of many listener-supported radio and television stations.



with a for-profit radio station, unlike overseas charity, does not stem from the fact that the contributor cannot determine whether the services promised are in fact being provided. Rather, the problem here is related to the indivisible nature of the service involved, which is what makes it a public good.<sup>48</sup> The listener knows what quality of broadcast is being provided, but he does not know whether his contribution is being used to pay for it. There is no observable connection between the amount of the individual's contribution and the quality of the broadcast.<sup>49</sup> The virtue of the nonprofit form of organization is that it can provide some assurance that in fact such a connection exists.<sup>50</sup>

### 2. *Contractual Alternatives*

The nature of the contract-failure problem, and the way in which nonprofits provide a response to that problem, may become clearer if we focus more closely upon the contractual difficulties involved in the example just developed. In particular, let us consider whether it might not be possible for the owners of a commercial-free broadcasting station to devise a contract for services that would give the consumer as much security as does the nonprofit form.

Obviously a contractual promise by the owners simply to spend all or most of the individual patron's payment upon production of broadcast services will be meaningless in itself. Because the services financed with the payment from the patron in question are undifferentiated

48. There is also a public good aspect to CARE. To many people the relief of suffering overseas is a good; for such individuals CARE provides a public good. Other individuals receive satisfaction not just from the knowledge that suffering has been relieved, but from the feeling that they have contributed to the relief of that suffering; for them CARE provides a private good. However, the problem of contract failure that gives rise to a nonprofit is the same in either case—namely, that the purchaser does not have adequate means of determining for himself whether his individual payment actually is being used to provide services (*i.e.*, relieve suffering) that would not otherwise have been provided. Thus, it is not the public nature of the good in itself that is important. Rather, the reason that nonprofits commonly provide public goods is that often such goods cannot be provided in any way in which it is easy for the purchaser to observe directly the incremental amount of the good that has been financed by his payment.

49. When an individual can determine the incremental amount of the public good that he has purchased, there is no reason to prefer a nonprofit supplier to a for-profit supplier. For example, for-profit providers are common where the purchaser takes delivery of the incremental amount of the public good himself before contributing it to the public stock—as when someone buys confetti that he then throws out the window on a parade, where it merges with the confetti thrown by thousands of others for a grand overall effect.

50. It should be clear by now in what way the contract failure problem that we are focusing on here is distinct from the standard public goods market failure—the free-rider problem. The latter is concerned with the lack of incentive to contribute to the cost of a public good, while the former is concerned with the inability to control the use to which a contribution is put once it is made.

from the services financed by other income, such a promise can have significance only if it is accompanied by an understanding that the compensation taken by the owners from other income will not be increased upon receipt of the patron's payment. It appears, then, that any contractual promise made by the owners to a given patron must make reference to the uses they will make of all of the organization's income, from whatever source it may derive. Such a promise might, for example, take one of the following forms:

- (1) The owners could promise that no more than, for example, five percent of the income they receive from all sources will be distributed to the owners as compensation and profits.
- (2) The owners could promise that the total amounts distributed to themselves as compensation and profits will not exceed a given dollar limit.
- (3) The owners could promise that the amounts distributed to themselves will not exceed "reasonable" compensation for the services and capital they contribute to the organization.

In each case it would need to be promised further that all amounts not distributed to the owners would be devoted to other expenses necessary for the production of broadcasts of the highest quality that those amounts permit.<sup>51</sup>

It is immediately apparent that all three of these approaches convert the nominally profit-seeking firm producing the broadcasts into what is essentially a nonprofit organization. That is, all three devices effectively limit the amount of the organization's income that can be appropriated by the owners. The third approach, limiting compensation to amounts that are "reasonable" for the services rendered, is in fact roughly the interpretation given to the nondistribution constraint by the law.<sup>52</sup> Approaches (1) and (2), so long as they are consistent with (3), can be seen simply as more specific versions of the latter standard,

51. An alternative approach utilizing the for-profit form would be to distribute stock in return for contributions. This would permit the donors to protect themselves through the exercise of formal control over the organization, rather than through contractual devices. However, such an approach is likely to be unwieldy where contributions are made in small amounts by a large number of people and are used primarily to cover current operating expenses. For example, the stock that was issued presumably would give a contributor a vote in perpetuity even if he had just made a single contribution long in the past. And ultimately all votes, whether attached to old or to newly issued shares, would become so diluted as to be meaningless.

If contributor control is to be effective, votes must be confined to current contributors. This is most easily accomplished by incorporating as a nonprofit or, alternatively, as a cooperative, *see* pp. 889-90 *infra*.

52. *See* ALI-ABA MODEL NONPROFIT CORPORATION ACT § 26 (1964).

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and therefore are also just private-contract versions of the nondistribution constraint.<sup>53</sup>

The difference between the contractual devices just mentioned and a formal nonprofit lies, then, not in the nature of the limitations imposed upon the managers but rather in the means by which they are established and enforced. Under the contractual approach, the patrons would need to insist upon receiving regular, audited financial statements from the firm containing sufficient detail to permit the patrons to determine whether the owners are adhering to the contractual constraints. Should it appear to a given patron at any point that the owners are not keeping their promises, then the patron would need to bring suit to enforce the contract. In contrast, under the nonprofit form, the state is empowered to bring suit if the organization's management compensates itself too generously.<sup>54</sup>

The advantage of the nonprofit form, then, is that it economizes on contracting and enforcement. Under the private contractual approach each individual patron not only must understand and agree to a complex contract but also must police the organization's finances as a whole—or rely upon other patrons to do so. Moreover, to the extent that patrons do engage in such policing, they may be duplicating each other's actions, since the activity that constitutes breach of the contract is presumably the same for all. Consequently, considerable economies can be realized by placing all such transactions under one collective contract between the organization and its patrons: the contract determined by the state's nonprofit corporation law<sup>55</sup> and policed by the state.<sup>56</sup>

53. In fact the device involved in (1), under which compensation is determined as a percentage of gross income, is commonly employed by nonprofits with the explicit sanction of the authorities who oversee them. For example, the income of the chief radiologist in a hospital is not infrequently determined as a fixed percentage of the radiology department's gross revenues. See Rev. Rul. 69-383, 1969-2 C.B. 113. Moreover, the usual method for compensating the trustee of a charitable trust is to give him a fixed percentage of the income and principal that he receives and pays out for the trust, and in many states this method—and the percentage to be employed—is provided for by statute. See 3 A. SCOTT, *supra* note 29, at § 242.

54. See Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433 (1960).

55. This contract is tailored by the particular terms of the organization's corporate charter. Moreover, individual patrons, whether donors or ordinary customers, can execute more detailed contracts with a nonprofit organization if they wish to. For example, donors commonly place restrictions upon the purposes to which their contributions can be devoted, and these are often enforceable. See W. CARY & C. BRIGHT, *THE LAW AND THE LORE OF ENDOWMENT FUNDS* 14-27 (1969). The nonprofit corporation statutes set out, in effect, the standard form for such contracts.

56. It is not clear, however, that states have been wise in making the state the only party that can bring suit. A more lenient standing doctrine could lead to more effective enforcement of the nondistribution constraint.

If "pay radio" were to become commercially feasible—that is, if there were some inexpensive means of making receipt of a radio station's broadcasts conditional upon payment of a periodic charge—then profit-seeking firms also would be able to engage in commercial-free broadcasting simply by charging their listeners directly, as is already happening in the television industry via cable TV. The result presumably would be a reduction in the willingness of listeners to make voluntary contributions to nonprofit stations, since such stations would no longer be as necessary to fill the need for commercial-free programming. Thus pay radio might be expected to supplant nonprofit listener-supported stations.<sup>57</sup> Such a result would be more efficient, in fact, since the free-rider problem would be eliminated.<sup>58</sup> In this case, therefore, it seems that nonprofit enterprise is simply a response to technical problems in pricing services.<sup>59</sup>

### C. *Price Discrimination*

There are further situations in which, as with public goods, the contract failure that ultimately gives rise to nonprofit producers grows out of other kinds of market failure. One of the most interesting of these,

57. Note that the thing that the patron is "buying" changes a bit when we move from the donative nonprofit broadcaster to the proprietary cable system, even when the two offer identical programming. In the case of the cable system, what the listener is buying with his payment to the station is access to its programs. He can tell easily enough whether he is in fact given such access after making his payment; consequently, there is no need to place any special trust in those who manage the system. With our hypothetical nonprofit broadcaster, on the other hand, the station has no way of preventing the patron from obtaining access to its broadcasts, and thus such access is not really what the patron is seeking to procure with his contribution. Rather, he presumably is seeking to help cover the indivisible costs of operating the station—that is, to "buy" resources for the broadcasting operation as a whole. As discussed above, he will have difficulty determining whether his payment is in fact being used for this purpose.

58. However, it would not be completely eliminated if subscribers differ in their marginal valuation of the service, yet are all charged the same fee to subscribe. This is an important difficulty for the performing arts and is a major reason for the predominance of the nonprofit form in that sector. See pp. 855-59 *infra*.

59. Many other public goods also are supplied by nonprofits. A more familiar example is basic scientific and medical research, which, to the extent that it is performed by non-governmental organizations, is conducted in large part by nonprofits, such as universities and independent research laboratories. In addition, there are a number of nonprofit organizations, such as the March of Dimes and the American Heart Association, that collect funds for such research and distribute them to the research institutions. Organizations that seek to influence the political process, such as Common Cause, the Sierra Club, and the Republican Party, also provide a public good to those individuals who share the organization's views. Similarly, organizations that lobby for particular sectors of industry, such as the American Petroleum Institute and the Motor Vehicle Manufacturers Association, provide public goods to the firms that are in the particular industry involved. These organizations are all nonprofit, rather than for-profit, for the same reason as in the case of the listener-supported radio stations discussed above.

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related to the public goods case just discussed, involved nonprofit organizations in the performing arts.<sup>60</sup>

At first impression, it is not obvious why the performing arts are typically the product of nonprofit institutions. To begin with, some portions of the sector, such as Broadway theater and summer stock, are vigorously for-profit, and profit-seeking firms played an even larger role in the past. Furthermore, the two factors discussed above that seem to go far toward explaining the need for donative nonprofits in a number of other areas—namely that the institution provides public goods or serves as an intermediary through which one group of people subsidizes the consumption of another—do not seem terribly important here.

To be sure, some contributions to performing arts organizations are probably made at least in part with the intention of making it easier for less prosperous individuals to attend. Yet most people who attend the performing arts are affluent; it seems unlikely that the primary reason that performing arts groups are nonprofit is to provide a vehicle for the rich to subsidize the upper middle class.<sup>61</sup> Similarly, it seems difficult to argue that the performing arts provide a service that is in any substantial degree a public good with respect to the community at large; in general, the only people who derive any benefit from a performance are those who are in the audience.<sup>62</sup>

60. The following discussion of the performing arts is in large part a condensation of Section I of Hansmann, *Nonprofit Enterprise in the Performing Arts* (Working Paper No. 808, Institution for Social and Policy Studies, Yale University (1978)).

61. See W. BAUMOL & W. BOWEN, *PERFORMING ARTS: THE ECONOMIC DILEMMA* 71-97 (1966). It is sometimes suggested too that the high-culture performing arts are nonprofit because it would simply be unthinkable tawdry to associate such things with commerce. This is unconvincing. For example, the same operatic and symphonic performances that are produced by nonprofits are also commonly recorded, reproduced, and distributed by profit-seeking record companies and stores and played on stereo equipment obtained from yet other profit-seeking firms.

62. Of course, there is something to the argument that great cultural institutions confer prestige on the city, the region, or the country as a whole, and in this respect supply a public good. It might also be argued that the maintenance of a highly cultured elite confers benefits on the public at large either through the ultimate trickle-down of their cultural values to the rest of society, or simply through the gracious spectacle they provide for others to contemplate. Yet these remote public benefits seem quite small in proportion to the private benefits that a performance confers on its audience—far smaller than the typical ratios of donations to ticket receipts in the high-culture performing arts. Surely these are not the most significant reasons for donations to the performing arts.

It seems that individuals also make donations in part because such donations, at least if they are published, or if they cause the donor to be admitted to the social circle of other substantial donors, may effectively “buy” the donor some social status. But such use of the nonprofit performing arts as an arena for conspicuous giving is most likely an epiphenomenon rather than a root cause of the evolution of donative nonprofits in that industry.

Nevertheless, many performing arts groups not only are nonprofit, but in fact depend on voluntary contributions for a substantial portion of their operating budgets.<sup>63</sup> The situation is all the more curious when we note that the great bulk of contributions received by the typical theater or orchestra is donated by the same people who buy tickets and attend the organization's performances.<sup>64</sup> Why is it that the organizations do not simply raise their ticket prices rather than try to coax part of the cost of the performance out of the audience in the form of donations?<sup>65</sup> Such behavior seems even more unusual when we observe that there is substantial evidence that organizations in the performing arts commonly charge ticket prices so low as to place them well within the inelastic portion of their demand curves; that is, if ticket prices were raised the decrease in attendance would be sufficiently small that the organization's total revenue from ticket sales would increase.<sup>66</sup>

Paradoxical though these facts may be, there in fact appears to be a simple, fairly straightforward explanation that goes far toward accounting for them. In this situation contributions are, in essence, a form of voluntary price discrimination, or, in other words, a means whereby different customers can be charged different prices for the same service. And in an industry such as the performing arts, in which fixed costs typically account for a large fraction of total costs, the availability of price discrimination can be the key to survival.

High-culture entertainment such as opera, ballet, and classical music generally appeals only to a small segment of the population of even large cities. Thus, there are seldom more than a few performances of a given production. The substantial start-up costs—that is, the costs incurred in organizing, rehearsing, and providing scenery and costumes for a given production—account for a large portion of the total costs that must be spread over the resulting performances. Once one performance of an opera has been staged, the additional cost of adding another performance is relatively small. Similarly, as long as the

63. Contributions commonly comprise between one-third and one-half of operating budgets. See W. BAUMOL & W. BOWEN, *supra* note 61, at 147-57.

64. Published studies of philanthropic support for the performing arts do not provide direct evidence on the percentage of contributions that come from individuals who attend, but the available information on the percentage of the audience that contributes is suggestive. For example, the Metropolitan Opera reported at one point that 55% of its subscribers were also contributors, and a survey of performing arts audiences in general found that roughly 40% of the respondents said they contributed at least occasionally and 15% said they gave regularly. See *id.* at 307-08.

65. The fact that donations but not ticket purchases can be deducted from income for federal tax purposes is undoubtedly a factor here, but surely is not the whole explanation.

66. See W. BAUMOL & W. BOWEN, *supra* note 61, at 272-78.

theater is not yet filled, the additional cost incurred by adding another member to the audience is very small, since it costs little more to stage a performance for a full house than it does to play to one individual.

The result is that, once a commitment has been made to have at least one performance of a given production, it becomes worthwhile to admit additional persons to the audience at a given performance, or to extend the number of performances, so long as the individuals who attend will pay a price just high enough to cover the small additional—marginal—cost involved. Yet it is generally difficult to set price much lower for one performance than for another or lower for one member of the audience than for another. And if the organization charges everyone just the cost of filling an additional seat, then the total cost of the production will not be covered because of the high fixed costs. A performing arts group is therefore likely to find itself facing two conflicting pressures: on the one hand, prices must be set high enough to cover the total costs of the production, while on the other hand, if prices are kept higher than the cost of adding another member to the audience or another performance to the run, then an opportunity for some additional net revenue will have been lost. Further, and more important, it appears that for many performing arts productions, there exists no single ticket price at which the total receipts from ticket sales will cover the total cost of the production.<sup>67</sup>

A solution to these problems is available, however, if the organization can engage in some form of price discrimination. It is worth a great deal to some people to be able to see a production by, for example, the Metropolitan Opera, while for others it is worth less—though still more than the cost of adding another member to the audience at a given performance. If everyone could be made to pay for a ticket roughly what it is worth to him, the total receipts for a production would be much higher than if the price is set at the amount that represents its worth to the member of the audience who values it least—which is the result with a single ticket price for everybody. To some extent, price discrimination of this sort can be accomplished by charging much higher prices for good seats than for bad seats, and in fact this is a common practice in performing arts organizations; the gains

67. As noted above, *see* note 63 *supra*, ticket receipts commonly cover only one-half to two-thirds of the cost of a typical performing arts production. Although an increase in ticket prices for many productions evidently would lead to an increase in total ticket receipts up to a point, it seems highly improbable that in many cases total ticket receipts could be increased in this way by the 50% to 100% margins that would be necessary to make those receipts cover total costs.

that can be achieved from this device alone, however, are necessarily limited.<sup>68</sup>

Individuals can, however, simply be asked to *volunteer* to pay an additional sum if the ticket price is lower than the value they place on the performance, and this is, in effect, what the nonprofit performing arts groups do. Of course, it is not entirely effective; most people will volunteer nothing or some amount less than their full valuation of the performances. Yet experience proves that many people will volunteer something.<sup>69</sup>

Only a performing arts organization that is nonprofit is likely to have much success in attracting such contributions, however, again for reasons of contract failure. There will be no observable connection between an individual's contribution and the quality of the performance that he sees. Consequently, the contributor needs the nondistribution constraint to assure him that in fact his contribution is being used to meet the costs of the firm's productions. Or, put differently, for those individuals who pay the admission price for a given production, any increase in the quality of that production is a public good; in this respect, the problem is analogous to that for listener-supported radio stations.<sup>70</sup>

Note that this view of the role of donations in financing the performing arts helps to explain why an organization might want to keep ticket prices lower than the level at which total ticket sales receipts are at a maximum. For there is every reason to believe that when ticket prices go up, donations will decrease, and thus the total revenue from ticket sales and donations combined may well be maximized at a ticket price lower than that which simply maximizes ticket receipts.

Presumably, Broadway theater is viable when operated on a profit-seeking basis because the shows it produces are sufficiently popular to enjoy, on average, long runs. Hence fixed costs can be spread over a large number of performances and are less significant relative to variable costs. The same thing is also true of other related industries, such as movies, television, and professional sports, which have continued to

68. In particular, this device can succeed only to the degree that patrons with relatively inelastic demand—that is, those who place a very high value upon being able to see a performance—show an exceptionally strong preference for good seats. Furthermore, the number of different price categories into which seats can practically be divided, and thus the refinement of price discrimination that is available, is restricted.

69. See note 64 *supra*.

70. The argument advanced here also suggests why it is that the role of nonprofits in the performing arts has increased over the past several decades; since there is strong evidence that fixed costs have been rising consistently as a proportion of total costs, see Hansmann, *supra* note 60, at 10, for-profit firms, which do not have access to price discrimination through voluntary contributions, and thus are dependent on ticket sales alone for their income, are less viable.



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be characterized by profit-seeking firms; while all of these industries exhibit high fixed costs, the significance of those costs is reduced since they can be spread over very large audiences.

If the analysis of the performing arts offered here is correct, then we can conclude that the nonprofit firms in this sector are in essence serving precisely the same general role as the for-profit firms—that is, they are selling performances to an audience. The difference lies simply in the manner in which the price is paid. Yet this difference is crucial. The nonprofit firm provides a vehicle—through the trust engendered by the nondistribution constraint—whereby the audience's willingness to pay more than the ticket price can be tapped, and this is the key to survival in many cases. It is the key, however, only because of a rather unusual confluence of demand and cost conditions in this industry.

Museums and libraries provide other examples of industries in which nonprofits have arisen largely because of the need for voluntary price discrimination. A large portion of a museum's costs, for example, are incurred in constructing the museum facility, and in acquiring objects and preparing them for display. Once an exhibit is prepared, the added cost of admitting one more person to see it is extremely low. This high ratio of fixed to variable costs, plus the relatively small audience for most museum exhibits<sup>71</sup> and the large variation among individuals in the valuation placed upon the opportunity to see such exhibits, makes voluntary price discrimination an important means of obtaining income,<sup>72</sup> just as in the performing arts.<sup>73</sup>

### D. *Implicit Loans*

Nonprofit organizations arise in certain situations as a response to legal and practical imperfections in loan markets. Private education

71. The recent phenomenon of lavish and well-publicized traveling exhibits, in which the art is brought to the people rather than vice versa, has increased the audience for some museum objects enormously and suggests that some museum holdings may be able to produce revenues through admissions charges that more than cover the costs of acquiring and maintaining those holdings. But so far this has been an exceptional development.

72. Indeed, one of the most unmistakable examples of voluntary price discrimination is provided by New York's Metropolitan Museum of Art, which requires all visitors to pay something to obtain admission, but leaves the amount of the payment to the discretion of each individual visitor.

73. Other factors are obviously important in explaining why libraries and museums are so commonly nonprofit. For one thing, because these institutions provide important resources for scholars, they provide a service that is in part a public good for the public at large, including those who never enter the institutions themselves. Also, these institutions are intermediaries for redistributive gifts—such as the gift of a large private collection of important paintings to the public at large. Thus libraries and museums also have something in common with the CARE and listener-supported broadcasting examples discussed above.

provides an example. Institutions of higher education commonly depend heavily on voluntary private contributions to cover their expenses. Why are these contributions necessary, and why do people make them? In part, such contributions undoubtedly reflect motivations similar to those we have already surveyed. Certainly some gifts are intended to help cover costs for students who come from families that would not otherwise be able to afford such schooling. To this extent, colleges play a role as philanthropic intermediaries in somewhat the same way that CARE does. To some extent, too, donations to colleges and universities are intended to help support the provision of public goods such as scientific research.<sup>74</sup> Yet these factors do not seem to account for the bulk of donations to institutions of higher education.

To begin with, donations come predominantly from alumni. Surely if a donor wished to secure the most effective use for his dollar, whether in providing higher education for the poor or scientific research, he would consider sending his contribution to institutions other than just his alma mater. In fact, many private liberal arts colleges that receive substantial contributions from their alumni do little research and have relatively few students from deprived backgrounds. Nor do the frequent appeals that such schools make to their alumni stress charity and public goods and aid to the poor; rather, they emphasize that contributions are needed to finance the general educational programs of the school.

In essence, the donations received by private colleges and universities are in large part simply a means by which past generations of students help to finance the education of the present generation of students.<sup>75</sup> Such a pattern of finance undoubtedly responds to a real failing in our market mechanisms—namely, the lack of an adequate system of educational loans.

For most people, a college education is probably a good investment in strictly financial terms; that is, it increases the present value of expected lifetime earnings by more than its cost.<sup>76</sup> For such people it would be worthwhile to borrow against their future earnings in order to pay the cost of higher education. Yet private lending institutions generally have not been willing to make such loans, due to problems

74. In general, education itself is not a public good, although there may be some public benefits associated with it.

75. This curious arrangement is almost unique to higher education; the only other private institution in which such intergenerational transfers are common seems to be the family.

76. See Brainard, *Private and Social Risk and Return to Education*, in *EFFICIENCY IN UNIVERSITIES* 241 (K. Lumsden ed. 1974).

in arranging for adequate security. To begin with, there is the problem of "moral hazard": the individual may never work hard enough to have sufficient funds to pay back the loan.<sup>77</sup> Legal restraints on personal servitude prevent the borrower from providing the lender with additional assurance on this score by giving the lender the right to "foreclose" on the borrower himself—that is, to place him in temporary bondage and force enough work out of him to make the required repayments. Finally, in order to be attractive, the loans would have to be of sufficient duration to permit the borrower to pay them off during his peak earning period, presumably thirty years or more after the loans were originally made. Yet both the bank and the borrower might reasonably feel that such a long-term fixed interest obligation would be unduly risky and would require too much effort on the part of the lender to keep track of the borrower for all those years.

The resulting unavailability of private loans means that, if private colleges and universities were to charge through tuition the full cost of the education they offer, they would be able to educate only the children of unusually prosperous families.<sup>78</sup> Instead, the private schools have in effect adopted a loan program with voluntary payback. Schools charge their students through tuition payments less than the full cost of education, but then impress upon their graduates their moral obligation to repay the loan that they have in effect received. Or, put differently, alumni contributions can be seen as essentially a means by which college students pay for their college educations on a voluntary installment plan. Of course, there is no legally enforceable obligation to pay anything to the school once an individual has graduated, and many alumni give nothing. But the schools constantly remind alumni of their moral obligation, and many alumni do give.<sup>79</sup> The nonprofit form is undoubtedly important in encouraging alumni to make the contributions on which the system depends, for reasons similar to those

77. The individual may even use the bankruptcy laws to free himself of the obligation entirely.

78. The current federally insured student loan program is an important response to the imperfections in the market for private loans described here. The effectiveness of that program is severely hampered, however, by the limitations upon the amounts that can be borrowed and, most importantly, by the requirement that the loans be repaid in full within ten years after graduation.

79. Undoubtedly other factors are also important. For example, an individual will to some extent be labeled throughout life as a graduate of the particular school he attended, and therefore has an incentive to see to it, through contributions, that the school remains as prestigious as possible. Since the school's prestige is a public good for its graduates, the analysis above, *see pp. 848-51 supra*, applies to contributions made for this purpose. Alumni contributions also serve as a form of voluntary price discrimination, much as in the case of the performing arts.

for listener-supported radio stations. An individual will be more willing to give money to a school if he knows that it will be devoted to providing education. Yet the contributor cannot tell whether his donation was used to further the educational goals of the institution, or whether, conversely, it simply went into someone's pocket. The nonprofit form provides some assurance to the donor in this regard.<sup>80</sup>

### E. *Complex Personal Services*

The preceding examples have all involved nonprofits that would be classified as donative under the categorization offered in Part I. While the need and motivation for the donations has varied from case to case, the ultimate problem of contract failure has been similar in each instance: absent the nonprofit form, the patron would have had no way of assuring himself that his donation ultimately was put to the purposes he intended. In some cases this was because the donor was not among the immediate recipients of the service he paid for, while in others it was because the patron was seeking to fund a small increment to a large-scale undertaking and had no way to observe whether that increment was in fact provided.

At first glance, commercial nonprofits raise different issues. By definition, the patron of a commercial nonprofit is engaged in a straightforward commercial transaction, purchasing a good or service provided exclusively to him for his personal consumption. Nevertheless, commercial nonprofits seem to respond to contract-failure problems similar to those found in the case of donative nonprofits. Commercial nonprofits typically arise in industries that provide complex personal services, as opposed to standardized industrial or agricultural goods. Often the complexity of these services, their nonstandardized character, and the circumstances under which they are provided make it difficult for the consumer to determine whether the services are performed adequately. Thus, the patron has an incentive to seek some constraints on the organization's behavior beyond those that he is able to impose by direct, private contract. Put differently, the services pro-

80. I do not mean to suggest that if the imperfections in the market for educational loans could be eliminated—as, for example, through an expanded system of federal loan guarantees, *see* note 78 *supra*—then we could expect that for-profit colleges and universities would begin to proliferate. There are undoubtedly other reasons, unconnected with alumni donations, for which higher education is typically nonprofit. Some of these reasons are explored further in a later section. *See* pp. 865-66 *infra*. I wish only to suggest that here, as elsewhere, nonprofit institutions serve to provide services that consumers might have difficulty obtaining satisfactorily through contractual arrangements with for-profit firms.

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vided by commercial nonprofits commonly require that the consumer entrust to the producer a great deal of discretion that the consumer is in a poor position to police. The nondistribution constraint limits the opportunity for the managers of the organization to abuse this discretion and consequently offers the consumer additional protection.

It is true, however, that when an individual is purchasing for his own personal consumption, as is generally the case with the services provided by commercial nonprofits, he is necessarily in a better position to police the transaction than when, as is commonly the case with donative nonprofits, he is purchasing public goods or services that are to be delivered to others. Consequently, while the problems of market failure that give rise to commercial nonprofits can be serious, they are, in contrast to the problems that give rise to donative nonprofits, rarely of such magnitude as to prevent patrons from ever turning to a profit-seeking provider. Thus we find that commercial nonprofits almost always operate in competition with proprietary firms that provide similar services, suggesting that the competing advantages and disadvantages of the two types of firms are closely balanced. In fact, profit-seeking firms have a significant, and frequently a dominant, share of the market in all of the important industries in which commercial nonprofits are to be found. Donative nonprofits, on the other hand, rarely have proprietary counterparts.

### 1. *Some Examples*

The following examples of industries composed at least in part of commercial nonprofit institutions may help to illustrate these points.

#### a. *Nursing Care*

Many of the nation's privately operated nursing homes for the elderly are nonprofit, though the majority are still proprietary.<sup>81</sup> The explanation for the high level of nonprofit activity in this sector does not appear to lie in any systematic difference in financing or services offered by nonprofit and for-profit institutions. Both types of institu-

81. In 1967, 77% of all nursing homes were proprietary, 15% were nonprofit, and 8% were governmental. See DEP'T OF HEALTH, EDUCATION, AND WELFARE, PUBLIC HEALTH SERVICE, VITAL AND HEALTH STATISTICS: DATA FROM THE NATIONAL HEALTH SURVEY, SERIES 12: NO. 16, NURSING HOMES: THEIR ADMISSION POLICIES, ADMISSIONS AND DISCHARGES 34-35 (1968). A more recent survey, which does not distinguish between nonprofit and governmental facilities, indicates that in 1977, 74% of all homes, accounting for 66% of all nursing home residents, were proprietary. DEP'T OF HEALTH, EDUCATION, AND WELFARE, PUBLIC HEALTH SERVICE, ADVANCE DATA FROM VITAL AND HEALTH STATISTICS OF THE NATIONAL CENTER FOR HEALTH STATISTICS, No. 35, at 2 (1978).

tions provide the same services—room, board, and skilled nursing care—and both are financed largely through patient revenues received either from the patients themselves or their families, or from insurance programs such as Medicare and Medicaid. Nonprofit nursing homes commonly receive little or no income from donations and thus fall in the category of commercial nonprofits.<sup>82</sup>

The reason for the proliferation of nonprofit nursing homes seems to lie, instead, in the nature of nursing care itself. The patients who receive the services often are too enfeebled to be able to judge effectively the quality of care they receive, or to press complaints against managers or to seek out an alternative institution. Furthermore, payment for the services often comes not from the patient himself, but instead, as in the CARE example, from a third party such as a medical insurance plan. In such cases only the third-party billpayer may have the leverage to insist upon adequate performance. Yet such a third party commonly has a much less direct stake in the quality of care provided than does the patient and may make little effort to inspect the home firsthand or even to communicate with patients competent to offer a useful critique. Moreover, even if the paying party is a relative of the patient and does seek to ensure that performance is adequate, contract failure may result. The patient may not be a useful source of information and it may be impossible to obtain an accurate idea of the quality of care through occasional visits. Because the quality of the nursing services and medication provided by a nursing home might be difficult to judge, a proprietary nursing home operator can often get away with providing low-quality services while charging exorbitant prices, or providing unneeded services and billing the patient for the cost. Worse, an unscrupulous operator may even use medications to sedate complaining patients.<sup>83</sup> For all of these reasons an individual might reasonably prefer to entrust his care and health, or those of a relative, to a nonprofit nursing home, whose managers are prohibited from appropriating earnings derived from deficient service.

Unfortunately, in the nursing home business many operators have found it relatively easy to circumvent, via various forms of self-dealing, the nondistribution constraint that is supposed to characterize non-

82. Less than 6.6% of residents in nonprofit and governmental nursing homes have their care paid for primarily by private charity. See DEP'T OF HEALTH, EDUCATION, AND WELFARE, PUBLIC HEALTH SERVICE, VITAL AND HEALTH STATISTICS: DATA FROM THE NATIONAL HEALTH SURVEY, SERIES 18: NO. 32, CHARGES FOR CARE AND SOURCES OF PAYMENT FOR RESIDENTS IN NURSING HOMES 13 (1977).

83. See M. MENDELSON, TENDER LOVING GREED (1974) (account of disturbing practices in nursing care industry).

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profit enterprise.<sup>84</sup> The rationale for nonprofit enterprise suggested here does not lose its force, however, simply because the nonprofit form has at times been abused. People undoubtedly patronize nonprofit nursing homes in the expectation that such institutions will be less likely than proprietary institutions to take advantage of the discretion that must necessarily be granted to them. The fact that such expectations are sometimes ill-founded does not belie the argument that they are a major source of the demand for the services of nonprofit institutions. In any case, nursing homes seem to be a deviant example in this regard. In no other important sector do nonprofit institutions appear to be so frequently just a cover for proprietary activity.<sup>85</sup>

### b. *Day Care*

Day care for young children, like nursing care for the elderly, is often provided by nonprofit institutions, though again proprietary organizations account for more than half of the existing facilities.<sup>86</sup> The factors responsible for the substantial proportion of day care centers that are nonprofit seem similar to those just considered in the case of nursing homes. While it is the parent who pays for the services rendered by a day care center, it is the child to whom these services are immediately rendered. Children typically are not very discriminating consumers, nor even, in many cases, good sources of information about the nature of the services they receive. In such circumstances it is natural for a parent to turn to a nonprofit provider on the assumption that such an institution will be less likely to abuse the trust that must necessarily be placed in it.<sup>87</sup>

### c. *Education*

It has been noted above that it is often advantageous for educational institutions to be nonprofit so that they can have access to donative financing. Yet there are reasons even for schools that are commercial, receiving most or all of their income from tuition payments, to be nonprofit. For private primary and secondary schools, considerations similar to those just suggested for day care centers apply: the parents are paying while the child is the direct recipient of the services, and the

84. *See id.* at 195-212.

85. Abuses have been observed in nonprofit institutions in other industries as well, however. *See Dionne, Levitt Audit Finds Overpayments to Private Schools for Handicapped*, N.Y. Times, Dec. 18, 1977, at 76, col. 3.

86. *See Nelson & Krashinsky, The Demand and Supply of Extra-Family Day Care*, in PUBLIC POLICY FOR DAY CARE OF YOUNG CHILDREN 9, 18 (R. Nelson & D. Young eds. 1973).

87. *See Nelson & Krashinsky, supra* note 2.

parents may not want to rely exclusively on the child for an evaluation of the quality of education provided. Moreover, education at all levels is a complex and subtle service, and in many cases a parent or a student may not feel competent to make adequate judgments about the quality of the teaching and facilities that an institution offers.

d. *Hospital Care*

Hospitals are perhaps the most common example of commercial nonprofits. Roughly ninety percent of all nongovernmental general hospitals are nonprofit.<sup>88</sup> Although a few hospitals, particularly the large teaching hospitals, might be classified as donative, the vast majority of nonprofit hospitals receive virtually all of their income from payments made by patients—either directly or through insurance plans—for services rendered.<sup>89</sup>

It can be argued that hospitals are commonly nonprofit for reasons similar to those just advanced to explain the presence of commercial nonprofits in other fields.<sup>90</sup> Yet here this line of reasoning is not entirely convincing. When a patient enters a hospital, he generally continues to be cared for by a private physician who is not an employee of the hospital, but rather bills the patient separately for his services. Moreover, it is the physician, not the hospital, who administers or is responsible for most of the crucial services received by the patient. The hospital, for the most part, provides relatively routine services, such as room and board, laboratory tests, and nursing care. Furthermore, it is the physician rather than the patient who generally orders particular hospital services, and who acts on behalf of the patient to make sure that the services are performed properly. That is to say, the physician acts essentially as a very sophisticated purchasing agent for the patient in the latter's dealings with the hospital. Thus the consumer appears to be no more at the mercy of a for-profit hospital than he is at the

88. In 1969, 87% of all nongovernmental hospitals were nonprofit and 13% were for-profit. Because for-profit hospitals tend to be smaller, nonprofits accounted for 94% of all beds, and for-profits for the other 6%. See Ferber, *An Analysis of Chain-operated For-profit Hospitals*, 6 HEALTH SERVICES RESEARCH 49, 50-56 (1971).

89. For the period 1962-1966, philanthropy accounted, on average, for only 2.4% of total hospital revenues. See K. DAVIS & R. FOSTER, COMMUNITY HOSPITALS: INFLATION IN THE PRE-MEDICARE PERIOD 44 (U.S. Dep't of H.E.W., Soc. Sec. Ad., Office of Research & Statistics, 1972).

90. The patient is commonly in a poor position to judge the quality of care he receives. The treatment administered is technical, and the patient is often not in any position to make consumer decisions. Consumers of hospital services might therefore appear to have a strong incentive to seek a supplier with a minimal incentive to take advantage of them.



mercy of a for-profit manufacturer of prescription drugs.<sup>91</sup>

Instead, historical factors probably play a large role in explaining why hospitals are typically nonprofit. In the nineteenth century, hospitals were almost exclusively charitable institutions serving as sick-houses for the poor<sup>92</sup> and thus were donative institutions.<sup>93</sup> In the twentieth century, however, changes in medical science and in the availability of insurance plans took hospitals almost entirely out of the business of charity and put them on a paying basis.<sup>94</sup> Yet, while private hospitals seldom take charity cases any more, so far they have remained largely nonprofit. This is probably not simply a matter of inertia and tradition. Doctors undoubtedly find this state of affairs profitable and thus have a strong interest in seeing it continued.<sup>95</sup> So long as hospitals

91. See Newhouse, *Toward a Theory of Nonprofit Institutions: An Economic Model of a Hospital*, 60 AM. ECON. REV. 64 (1970).

Existing data, although not conclusive, fail to confirm that nonprofit hospitals offer a higher quality of care than do proprietaries. For example, when figures are controlled for size of hospital there is no significant difference in the accreditation rates for nonprofit and for-profit hospitals. In fact, when one considers only publicly held, chain-operated for-profit hospitals, the accreditation rate is actually higher than it is for nonprofits. See Ferber, *supra* note 88, at 53. But see Newhouse, *supra*, at 69 (comparing accreditation rates without accounting for size differences).

92. See Bromberg, *The Charitable Hospital*, 20 CATH. U.L. REV. 237, 238-40 (1970).

93. See Lee & Weisbrod, *Collective Goods and the Voluntary Sector: the Case of the Hospital Industry*, in B. WEISBROD, *supra* note 2, at 77 (arguing that, based on empirical evidence, nonprofit hospitals serve as providers of public goods). If these authors are right, then the discussion above, *see pp. 848-54 supra*, would help to explain hospitals' nonprofit status. However, it is difficult to draw clear conclusions from the authors' data. At best the data show that the service mixture that nonprofit hospitals provide is more like that of governmental hospitals than like that of proprietary hospitals—a result that could be explained by various plausible alternative hypotheses that have nothing to do with public goods. Further, in addition to various limitations noted by the authors, the data fail to control for the size of hospitals, nor do they segregate out those hospitals with university affiliations that, unlike other nonprofit hospitals, undertake substantial amounts of research, teaching, and care for the indigent, and to which the analysis above, *see pp. 846-47, 859-61 supra*, therefore clearly applies to some degree. Finally, it seems implicit in the authors' argument that the public goods component of hospital production will be funded by donations. Yet, as indicated above, *see note 89 supra*, donative financing constitutes an extremely small fraction of the revenues of nonprofit hospitals.

94. There have been three important steps in this transformation. First, as medical science became more sophisticated, hospitals came to be places where people of all classes went to receive treatment too complex to be administered in the home. Second, with the development of first private and then public health insurance in recent decades, the ability of hospitals to collect payment for their services increased dramatically. And third, since the 1920's a system of public hospitals has developed to take care of indigents, thus relieving private hospitals of even that small segment of the population that is not presently insured in some form or other.

95. See Pauly & Redisch, *The Not-For-Profit Hospital as a Physician's Cooperative*, 63 AM. ECON. REV. 87 (1973).

Similarly, the degree of control that doctors exercise over a hospital with which they are affiliated is probably much larger if that hospital is nonprofit rather than for-profit—at least as long as the owners of the for-profit hospital are not the doctors themselves, but

bill patients at no more than cost for their services, doctors have a bit more freedom to raise their own fees.<sup>96</sup> It is rather as if a foundation, tax-exempt and supported in part by public contributions, were to build office space and then lease it at cost, or less, to Wall Street law firms. One would not expect to see the lawyers in a hurry to have the foundation converted into an ordinary profit-making landlord.

In any event, a shift in the organization of the hospital sector is taking place. In the past, proprietary hospitals were typically small institutions, serving only the patients of the handful of doctors who owned them. As such hospitals grew, they were commonly converted into nonprofits.<sup>97</sup> Since 1967, however, publicly traded for-profit corporations have begun entering the hospital industry, acquiring ownership of large chains of hospitals, many of them formerly nonprofit.<sup>98</sup> If the trend continues, the hospital industry may someday cease to be dominated by nonprofits—though other factors, such as national health insurance, may also have a strong influence on the future organization of hospitals.<sup>99</sup>

## 2. *Comparison with Services Provided for Profit*

There are, of course, many goods and services that are not easily evaluated by consumers, yet are commonly provided by for-profit firms.

are outside investors. For example, a doctor may be able to induce a nonprofit hospital more easily than a for-profit hospital to buy an expensive piece of equipment that will help him increase considerably the size and profitability of his practice, even though the equipment is not cost-justified. See E. KAITZ, *PRICING POLICY AND COST BEHAVIOR IN THE HOSPITAL INDUSTRY* 77-80 (1968).

96. See Pauly & Redisch, *supra* note 95, at 97-98 (sketching alternative theory for dominance of nonprofit form among hospitals). Pauly and Redisch argue that, first, due to transaction costs and problems of monitoring, it may be most efficient if doctors have effective control over all aspects of the production of hospital services, and second, to keep productivity incentives for doctors sufficiently high, it may be necessary to let doctors capture any returns to hospital-based services above non-physician costs—which means, in particular, that contributors of capital must not be allowed to share in profits. The nonprofit form answers both these needs.

This theory is not particularly convincing. There would seem to be a variety of contractual and ownership arrangements that could maintain the beneficial aspects of physician control in the context of proprietary hospitals. Moreover, the distorted incentives for capital allocation that arise in nonprofit hospitals seem a very high price to pay for the benefits, if any, of creating increased productivity incentives for physicians by allocating to them 100% of the net income from hospital services.

97. See Steinwald & Neuhauser, *The Role of the Proprietary Hospital*, 35 *LAW & CONTEMP. PROB.* 817, 820 (1970).

98. See Ferber, *supra* note 88.

99. The widespread use of third-party payment systems for hospital expenses may be eroding further any differences between the quality and cost of services provided by nonprofit and for-profit hospitals. The incentives for a hospital's management created by the third-party payment schemes may dominate any differences in incentives that derive from the form of incorporation.

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Medicinal drugs, and the services of doctors, lawyers, automobile repairmen, and television repairmen provide examples. What distinguishes these services from those provided by nonprofits, and by commercial nonprofits in particular?

To begin with, while the consumer may be more or less at the mercy of the supplier in any given transaction involving drugs or the services of professionals and repairmen, such transactions are generally small and discrete and the costs of switching to another supplier are typically limited. As a consequence, the potential hazards involved in any given transaction are often relatively small. Further, in such circumstances the consumer has, as a means of disciplining the supplier in addition to enforcement of the original contract for services, the threat of taking his future business elsewhere if he should have reason to doubt the quality of performance. And finally, by switching suppliers from time to time the consumer may be able to educate himself somewhat about their services. In many cases, special institutions other than those with nonprofit status have arisen to provide consumers additional protection. Doctors and lawyers, for example, must be licensed and are subject to some degree of supervision and discipline from their respective professional associations. Ethical drugs are subject to federal regulation for quality and efficacy, and are available to the consumer only with a doctor's prescription.

In other industries, consumers seem to be at the mercy of for-profit providers, yet protective institutions have not developed to any significant degree. Among the services mentioned above, automobile and television repair fall into this category. In cases such as these, however, the mere possibility of developing special policing mechanisms may help to explain the relative absence of nonprofits. Thus, in the case of automobile and television repair—as opposed to the complex human services commonly provided by commercial nonprofits—it appears that a simple inspection and certification scheme probably would be sufficient to eliminate most of the problems that consumers face. The apparent lack of demand for such inspection schemes suggests that consumers are not overly concerned about their ability to judge the cost and quality of service that they receive from automobile and television repairmen.<sup>100</sup>

The nature of the risks confronting the consumer also may be important in distinguishing those cases in which consumers turn to non-

100. That lack of concern, however, does not mean that consumers should not be concerned.

profit producers. Where the services provided by for-profit producers are concerned, it appears that the major risk facing the consumer is generally that the producer will charge for work that was unnecessary and perhaps that was not done, rather than that the basic problem that caused the consumer to seek the service will not be solved—at least eventually. Thus, the customer's television probably will come back from the shop in decent working order, a result that he is easily able to check. The risk he runs is that he will be charged \$100 for a \$5 adjustment. When we look at the types of services provided by the major categories of commercial nonprofits, on the other hand, it seems that the producer is often in a position to get away with providing less than the minimal service the consumer requires. A day care center may be able to provide less nutrition, education, recreation, affection, or discipline for the children in its care than the parents would willingly tolerate, yet run only a minimal chance that many of the parents will become aware of it.<sup>101</sup> Since the value of such services to the consumer often is far in excess of their cost of production, to be deprived of the service itself can be far more damaging than simply to be overcharged for it.<sup>102</sup>

The prevailing size of the organizations in an industry seems to be another significant factor. The distinction between the for-profit and nonprofit forms becomes blurred when the organizations in question are small in scale, and thus the nonprofit form tends to lose its distinctive advantage in such cases. Consider, for example, a lawyer in solo practice who bills his clients by the hour. Since he only gets paid at what is presumably the going rate for his labor services, his law office is, in a sense, conducted on a nonprofit basis. Thus his business might not operate much differently if he were to establish it formally as a nonprofit rather than as a sole proprietorship. Similarly, if a person operates a small day care center out of his own home, employing few or no persons other than himself, the flow of funds and even the book-keeping might look much the same whether the organization is formally

101. The relative magnitude of the risks involved may be another important factor. A person may be more willing to take chances on the quality of care given to his ailing television or to his automobile than to his ailing heart or to his only child.

102. Furthermore, when an individual is simply overcharged for a service, then, particularly if the price has been agreed to in advance, the price is still generally less than the value to the individual of having the service performed, and therefore he still derives a net benefit from the transaction. To put the point in technical terms, the individual has simply been deprived of some of his potential consumer surplus. When, on the other hand, an individual pays for a service that in fact is not performed, or at least not performed adequately, the transaction can be a net loss for him, depriving him not only of all of his potential consumer surplus but of some or all of the value of the purchase price as well.

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created as a nonprofit or a for-profit entity. The nondistribution constraint that characterizes the nonprofit form has real meaning only when an enterprise is of sufficient scale to develop large earnings that cannot easily and plausibly be paid out simply as reasonable salaries to the individuals in control of the enterprise.<sup>103</sup> This may be an important reason why the service industries that are dominated by nonprofits, such as education and hospital care, are those that exhibit substantial economies of scale, while the service industries in which nonprofits are significantly outnumbered by proprietary firms, such as day care and nursing care, are those in which the efficient scale of enterprise is rather small.

Finally, two other considerations that I shall explore at greater length below may play a role here: first, it may be that, for reasons rooted in cultural norms or individual preferences, the constraints of the nonprofit form operate more effectively for some types of services than for others; and second, the liabilities that accompany the nonprofit form may vary from one industry to another.

We should not, in any case, be surprised that there are service industries in which there is evidently some degree of contract failure, but in which nonprofit firms have not come to play a significant role. As I have already noted, when an individual is purchasing private goods for his personal consumption, contract failure is unlikely to achieve such proportions as to make for-profit producers completely unworkable. In such circumstances, the extra degree of protection afforded by the nonprofit form is at best marginal. This is particularly evident when we consider that the nondistribution constraint is a rather crude consumer protection device; it may be an appropriate counter to the gross forms of contract failure that characterize the situations in which donative nonprofits are found, but it is a blunt instrument with which to attack the more limited forms of contract failure involved in the private provision of personal services. We have seen that there is no important service industry in which commercial nonprofits have entirely supplanted proprietary firms, and that in a number of industries in which commercial nonprofits are found, such as day care and nursing care, the nonprofit firms are substantially outnumbered by their for-profit competitors. It is therefore understandable that, when the complex of factors that determine the degree of contract failure in a given

103. Indeed, the difficulty of distinguishing reasonable salaries from returns to capital and pure profits in small, closely held business corporations is presumably one of the considerations that underlies Subchapter S of the Internal Revenue Code, I.R.C. §§ 1371-1379, which permits such corporations to elect to avoid the corporate income tax completely.

industry and govern the effectiveness of the nonprofit form in that industry assume a slightly different configuration, nonprofit firms are found to occupy no significant niche at all.

### 3. *Nonprofits as Producers of Services*

Virtually all nonprofits, and particularly commercial nonprofits, are producers of services; they are nearly nonexistent in the industrial sector of the economy. The preceding discussion suggests several reasons why this is so.

First, services are more complex to evaluate than are industrial goods, which typically are highly standardized, objectively describable, and easily compared. Consequently, if an important reason for having a nonprofit producer is to mitigate the risks to the consumer in obtaining a good or service that is inherently difficult to specify or evaluate, then nonprofits should naturally be expected to be more abundant in the service sector.

Second, services are often personal; one person cannot take delivery of them and then pass them on to another. As a result, if an individual is to pay for another's consumption of a service, as opposed to a manufactured item, it generally will be impossible for him to take delivery himself, inspect it, and then send it along to the donee; he will simply have to pay the supplier and trust that the donee will receive what was intended. As suggested above, the donor might be more willing to trust a nonprofit provider than a for-profit provider in such circumstances.

Finally, the production of services, as compared with most industrial enterprises, is often labor-intensive. Since, as discussed below, the availability of capital appears to be a major stumbling block to the development of nonprofit firms, this too suggests that nonprofits should be found more frequently in the service sector.

In this connection it is worth noting that our economy has been shifting markedly in recent years from industrial activities toward services, and it appears that this pattern will continue.<sup>104</sup> As a result, the importance of nonprofit enterprise should continue to grow in the years to come.

### F. *Donative Versus Commercial Nonprofits*

By now it should be clear that the distinction drawn in Part I between commercial and donative nonprofits is simply one of degree, rather than a difference in kind. As I have been suggesting here, the

104. See V. FUCHS, *THE SERVICE ECONOMY* (1968).

contributions made to donative nonprofits can be viewed simply as, in a sense, payments for services to be rendered. They differ from the usual payments for goods and services obtained on the market only in that there is generally no well-defined individual contract, express or implied, between the purchaser and the organization that spells out the precise services that the organization is to provide in consideration for the purchaser's payment. Instead, the purchaser relies on the organization's nonprofit charter for assurance that his payment will be used as he intends; in other words, the organization's charter sets out the terms of the contract between the patron and the organization. There is thus a strong commercial element in donative nonprofits; they are, in effect, engaged in the sale of services.

Conversely, we should not exaggerate the specificity of the individual contract between a patron and a commercial nonprofit. As we have noted, commercial nonprofits commonly serve in industries where it is difficult to specify with any precision just what services the organization is to provide to a patron; rather, the patron generally must yield some discretion to the organization in this regard. Thus, payments made to commercial nonprofits are, to an extent, contributions to the organization to be used as the organization chooses—constrained, again, by the purposes set forth in its charter. Or, in other words, there is a substantial donative element to many commercial nonprofits.

#### IV. A Closer Look at the Nondistribution Constraint

In the preceding discussion I have stressed the nondistribution constraint as the essential characteristic that permits nonprofit organizations to serve effectively as a response to contract failure. The extent to which the managers of nonprofits actually adhere to this constraint is therefore an issue of some importance.

##### A. *The Effectiveness of Legal Sanctions for Distributing Profits*

Although the prohibition on distribution of profits is more or less clearly embodied in the nonprofit corporation law of nearly all the states, most states in fact make little or no effort to enforce this prohibition. As a rule, its enforcement is placed exclusively in the hands of the state's attorney general; private parties, such as donors and consumers, generally lack standing to bring suit against the organization or its officers on this issue.<sup>105</sup> Yet in most states neither the office of the

105. See Karst, *supra* note 54, at 445-49; note 56 *supra*.

attorney general nor any other office of the state government devotes any appreciable amount of resources to the oversight of nonprofit firms.<sup>106</sup>

If, however, the organization is exempt from the federal corporate income tax, as most nonprofit enterprise is, then the Internal Revenue Service may well take an interest in whether there is any distribution of profits.<sup>107</sup> Any organization that violates the nondistribution constraint imposed by its corporate charter is also likely to run afoul of the parallel provision in the tax law, and thereby run the risk of losing its exemption. Yet even the IRS has not been particularly zealous in this area<sup>108</sup>—perhaps because its primary sanction, denial of exemption, seems too drastic a response to a bit of self-dealing on the part of an institution's managers, particularly when it may well be the patrons of the institution who will suffer the most from it.<sup>109</sup>

With such limited policing, it is not surprising that the managers of many nonprofit organizations succeed, to a greater or lesser extent, in evading the nondistribution constraint and in enriching themselves at

106. See Karst, *supra* note 54, at 449-60; Office of the Ohio Attorney General, *The Status of State Regulation of Charitable Trusts, Foundations, and Solicitations*, in V COMM'N ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS, RESEARCH PAPERS 2705, 2710-25 (1977).

107. Section 501 of the Internal Revenue Code, from which most nonprofit organizations derive their exemption from the corporate income tax, does not condition the exemption upon an organization's being formally established as a nonprofit. Thus, an organization's violation of the terms of its nonprofit corporate charter, including the nondistribution constraint, is not in itself grounds for loss of its tax-exempt status. The Internal Revenue Code does, however, have a nondistribution requirement of its own that stands as a condition for exemption. For example, the subsection of Section 501 under which most operating nonprofits receive their exemption from the federal income tax describes organizations that qualify for exemption as follows:

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 (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, *no part of the net earnings of which inures to the benefit of any private shareholder or individual*, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation, (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

I.R.C. § 501(c)(3) (emphasis added).

108. The state tax authorities concerned with administering the exemption of nonprofits from state property, sales, and income taxes generally become concerned in a particular case, it appears, only after the Internal Revenue Service has acted, and therefore do not constitute a substantial independent means of enforcement. See Karst, *supra* note 54, at 442-43.

109. See *The Role of Private Foundations in Today's Society: Hearings Before the Subcomm. on Foundations of the Senate Comm. on Finance*, 93d Cong., 1st Sess. 271-74 (1974) (statement of Sheldon Cohen).



the expense of the organizations and their patrons. The means used may be excessive salaries, low-interest loans from the organization, personal services and amenities paid for out of the organization's funds, excessively generous contracts for services provided to the organization by businesses owned by the managers, or the purchase or lease of real estate by the organization from its managers at inflated prices, mortgage interest, or rents.

It has already been noted that such devices seem to be disturbingly common in the nursing home industry. In addition, allegations of profiteering have been leveled at a variety of other types of nonprofits, including hospitals,<sup>110</sup> private schools,<sup>111</sup> and workshops for the blind.<sup>112</sup> Obviously such abuses, or even the potential for them, weaken the nonprofit form by undermining its effectiveness as a response to contract failure.

### B. *Normative Constraints on Profiteering*

Nevertheless, these abuses appear to be the exception rather than the rule; in spite of minimal policing of the nondistribution constraint, nonprofit institutions in most industries evidently are operated on a fairly circumspect basis. Such broad compliance with a poorly policed constraint is presumably due to adherence to social norms that reinforce the legal restraints on profiteering by conditioning individual behavior even when the legal constraints are unlikely to be enforced. Indeed, such ethical constraints may be far more important than legal sanctions in causing the managers of nonprofits to adhere to their fiduciary responsibilities.

Of course, such normatively conditioned behavior is important in all areas of economic life.<sup>113</sup> The successful operation of any economy requires a general willingness to play by the rules of the game even when the umpire is not watching.<sup>114</sup> What is of particular interest here is that, where nonprofits are concerned, such norms may have achieved more substantial development in some industries than in others. For example, in such areas as hospital care and higher education, which have been predominantly nonprofit for centuries in Anglo-American society, it appears that norms prohibiting profiteering have taken deep root. Yet

110. See *Kenner v. Commissioner*, 318 F.2d 632 (7th Cir. 1963).

111. See *N.Y. Post*, Oct. 27, 1977, at 1, col. 6.

112. See *Wall St. J.*, Jan. 24, 1979, at 1, col. 1.

113. See K. ARROW, *THE LIMITS OF ORGANIZATION* 23-29 (1974).

114. See McKean, *Economics of Trust, Altruism, and Corporate Responsibility*, in *ALTRUISM, MORALITY, AND ECONOMIC THEORY* 29 (E. Phelps ed. 1975).

in more recently developed, and therefore less tradition-bound, sectors, such norms may be weaker. Perhaps this explains in part the difficulties in the nursing home sector, which has grown from almost nothing into a large industry in the past forty years.<sup>115</sup> Also, in industries such as nursing homes, the presence of a substantial number of for-profit competitors may weaken normative restraints; the standards of service and conduct set by the proprietary firms eventually may be taken as an acceptable minimum even among the nonprofits. The importance of such ethical constraints may also explain why so many nonprofit institutions—including, for example, schools, hospitals, nursing homes, foster homes, and even housing project sponsors—are affiliated with religious groups. For such an association may help to keep the norms intact and at the same time assure potential patrons that in fact they *are* intact.<sup>116</sup>

Further, it seems likely that normative constraints operate more effectively in large organizations than they do in small ones, since in large organizations the activities of managers are exposed to the scrutiny of a larger number of other employees, and are also subject to the limitations imposed by bureaucratization. Thus, this is another reason why the typical size of organizations in a given sector, which is determined in large part by economies of scale, seems positively correlated with the extent to which nonprofits are established in the sector.

### C. *Screening Phenomena*

Finally, the nondistribution constraint may gain added strength by screening selectively for a class of entrepreneurs, managers, and employees who are more interested in providing high-quality service and less interested in financial rewards than are most individuals. That is, the nonprofit form both may restrain the managers of the organization, whatever their personal desires, from profiteering at the expense of the organization's patrons and may select as managers precisely that class of individuals whose preferences are most in consonance with the fiduciary role that the organization is designed to serve.

One possible form that screening of this type might take is sketched in the Appendix. As noted there, such screening might also have consequences for the competition that takes place between nonprofit and for-profit firms within a given sector.

115. DEPT OF HEALTH, EDUCATION, AND WELFARE, PUBLIC HEALTH SERVICE, PUB. NO. 616, THE NATION'S HEALTH FACILITIES, TEN YEARS OF THE HILL-BURTON HOSPITAL AND MEDICAL FACILITIES PROGRAM, 1946-56, at 83-86 (1958).

116. I am indebted to Robert C. Clark for this point.

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### V. Some Problems with the Nonprofit Form

As suggested in Part II, there are liabilities as well as benefits to the nonprofit form of organization.

#### A. *Limitations on Raising Capital*

Because nonprofits are unable to sell equity shares, they must rely largely upon donations, retained earnings, and debt for capital financing. The funds available from these sources may, however, be poorly matched to the capital needs of the organization. Donations may reflect merely the whims of contributors. Sufficient retained earnings to finance major capital expansion may take too long to accumulate and of course are not available at all to a newly founded organization. Debt financing, which generally is available for only a fraction of the investments made by for-profit firms, is even more limited for nonprofits because of the poor fungibility of the organization's assets and the negative effect on the creditor's public relations in case of foreclosure. Thus, while some institutions have accumulated endowments in excess of their needs,<sup>117</sup> many others are sorely strapped for the capital funds necessary to meet the burgeoning demand for their services.<sup>118</sup>

#### B. *Cross-Subsidization*

The nondistribution constraint provides the consumer with some assurance that the sums he pays to a commercial nonprofit will go in their entirety to the production of services. It offers no assurance, however, that the services he pays for will be provided to *him*. In general, a nonprofit remains relatively free to use the sums paid by one consumer to subsidize another, especially if, as is often the case, the consumer is in a poor position to determine whether he is getting exactly what he paid for. As one example, it appears that nonprofit hospitals commonly use profits derived from some of their routine services to finance other services, such as open-heart surgery units, that are characterized by such high costs and low demand that they cannot pay for themselves. Similarly, some nonprofit hospitals use profits from services

117. Boys Town, for instance, through highly effective fund-raising, had by the early 1970's accumulated some \$225 million, seemingly far in excess of what was needed to place its modest activities on a sound financial footing. N.Y. Times, April 16, 1974, at 41, col. 1.

118. See Steinwald & Neuhauser, *supra* note 97, at 817 (arguing that proprietary hospitals have developed primarily where expanding demand for hospital services has outstripped the ability of nonprofit hospitals to raise capital).

provided to paying patients to cover the cost of serving indigent patients. Whether such cross-subsidization is undesirable as a matter of policy depends upon the degree to which it fosters the provision of services whose costs exceed their benefits and the nature of the interpersonal redistribution to which it gives rise.<sup>119</sup>

### C. *Incentives for Managerial Efficiency*

The profit motive encourages efficient production. A profit-seeking entrepreneur has an incentive to choose the least costly means of producing a given service. Nonprofits might therefore be expected to be less vigilant in eliminating unnecessary expense than are their for-profit counterparts.<sup>120</sup> Whether this is so depends upon the factors that actually motivate the managers of for-profit and nonprofit firms. Thus, the familiar separation of ownership and control in large publicly held corporations may sometimes leave the management of such firms as free as the management of a nonprofit to select the goals to be served by the firm and to decide how efficiently it will be run. Some data suggest that, in the hospital industry at least, nonprofits are in fact managed somewhat less efficiently than their for-profit counterparts.<sup>121</sup>

### D. *Incentives for Entry and Growth*

The profit motive also provides a mechanism for ensuring that firms enter an industry and expand when demand for that industry's products or services increases. Nonprofits may, therefore, be less responsive to changes in demand, even when the availability of capital is not a constraint. There is reason to believe, however, that the disparity in behavior between nonprofit and for-profit firms in this regard is not overwhelming.

Legal restraints on the formation of for-profit firms act in some respects like the restrictions on nonprofit firms. For example, state corporation law commonly makes it difficult for entrepreneurs to take stock in the firm they create as a means of providing compensation for their future services.<sup>122</sup> Thus, if an individual does not have capital to contribute, the most he can expect to get in return for helping to form and operate a profit-making corporation may be a position of employment with the firm. In such cases, there is little more incentive to form

119. See *id.* at 832-34.

120. See Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972).

121. See Clarkson, *Some Implications of Property Rights in Hospital Management*, 15 J. LAW & ECON. 363 (1972).

122. See Herwitz, *Allocation of Stock Between Services and Capital in the Organization of a Close Corporation*, 75 HARV. L. REV. 1098, 1098-1100 (1962).

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a for-profit corporation than a nonprofit corporation. Nor is it clear that nonprofits will always expand at a slower rate than will profit-making firms. It has been suggested that nonprofits may often be output-maximizers—that is, firms that produce the largest amount of goods or services possible, given the constraints imposed by their income and the availability of capital.<sup>123</sup> As long as capital is available, such firms could be expected to expand to meet demand at least as quickly as a for-profit firm.

### E. *Implications for the General Theory*

If there were no special disadvantages to the nonprofit form of organization, one would expect nonprofit firms to displace profit-seeking firms in all industries. That is, if the only thing distinguishing nonprofit firms from for-profit firms was the fact that, by virtue of the nondistribution constraint, in the nonprofit firm price never exceeds cost, then there would be no situation in which a for-profit firm would have a competitive advantage over a nonprofit firm.

As the preceding discussion suggests, however, nonprofit firms are at a disadvantage relative to for-profit firms in various respects, including access to capital, efficiency of operation, and speed of entry and growth in expanding markets. Consequently, whether nonprofit firms are more suitable than for-profit firms in any given industry depends upon the balance of competing factors. Only if, in any given case, the protection afforded patrons by the nondistribution constraint is so valuable as to outweigh the disadvantages just mentioned will nonprofit firms have a competitive edge. Conversely, where, as in the case of most industrial goods, contract failure is not much of a problem, and hence the nondistribution constraint gives the consumer little added protection, the balance clearly tips in favor of proprietary firms.

## VI. Some Unconvincing Alternative Theories

Having developed the contract failure theory of the role of nonprofit organizations, it is instructive to contrast that view with various alternative theories that one occasionally encounters.

### A. *The “Unprofitable” Character of Nonprofits*

It is sometimes said that various activities are undertaken by nonprofit organizations rather than by for-profit organizations because

123. See Feldstein, *Hospital Price Inflation: A Study of Nonprofit Price Dynamics*, 61 AM. ECON. REV. 853, 855 (1971); Newhouse, *supra* note 91.

“they don’t pay” or because “you can’t make a profit from them.” While there is a sense in which such statements are true, they reflect a confused notion of the role of nonprofit enterprise.

All nonprofit organizations, just like profit-seeking organizations, ultimately must cover the full economic cost of all resources that they consume, including both the cost of labor and all other variable inputs and a reasonable return on any capital employed in their activities. There is no magic by which a nonprofit firm can produce a service at a lower cost than can a for-profit firm. Rather, the distinction between a nonprofit and a for-profit firm lies, not in how much the services cost, but in who pays and under what conditions they pay. Thus, while nonprofits often receive cost subsidies, public and private, direct and indirect, this does not mean that such organizations can produce their services at lower cost; it only means that part of the cost is paid by the patrons providing the subsidies. Indeed, in situations in which nonprofits arise, those who pay are often different from those to whom the services are rendered. The nonprofit form develops because, for this and other reasons, the organization’s patrons would find it difficult to draw up a contract with a profit-seeking firm that would give them adequate assurance that the firm would produce the desired services in return for their payment.

To be sure, this can be put another way: Because of the difficulty of forming and enforcing a satisfactory contract, a profit-seeking firm that tried to offer services such as listener-sponsored broadcasting or aid for starving children overseas would be able to attract few patrons, if any, and thus would not be able to remain in business. In this sense, then, the business “wouldn’t pay” for a profit-seeking firm. One suspects, however, that this is not what is meant by those who use such language. Rather, what they have in mind is, for example, that the recipients of CARE’s overseas assistance would not be able to pay for it, and thus no “profit” can be earned by trying to sell such services to the recipients. But such reasoning misses the important organizational question. The issue is not whether poor people overseas can afford to pay for better food, but rather, given that Americans are going to pay for the food, what kind of organization will Americans patronize to perform the delivery?

#### B. *The “Unseemliness” of Profits from Vital Services*

It is also commonly suggested that certain services, such as hospital care, are organized on a nonprofit basis because it would be unthinkable to have people profiting from the misery and ill health of others

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or to leave the availability of such vital services in the hands of profit-seeking entrepreneurs. Such reasoning is unpersuasive. Medicinal drugs, for example, constitute an essential element in modern medicine, yet are produced almost exclusively by for-profit firms and are distributed by proprietary pharmacies. Moreover, food, even more critical to life than medical care, is produced and distributed by profit-seeking firms without offending most people's sensibilities.

I do not mean to suggest that the importance of a service to health and welfare is irrelevant in determining the organizational structure of the firms providing it.<sup>124</sup> However, the fact that a good or service is of vital importance is neither necessary nor sufficient to lead to its production on a nonprofit basis. The central factor, rather, seems to be contract failure. Thus, food, the most fundamental of all necessities, is of such a simple and standardized character, is purchased by the average consumer so repetitively, and is available from so many different suppliers, that most consumers can obtain satisfactory service from profit-seeking suppliers. What is "unseemly" is the prospect of having an organization deliver important services of inadequate quality and at prices far in excess of cost, which will only happen when for some reason competitive markets do not work well.

### C. *Tax Incentives*

Many nonprofit organizations enjoy special treatment under state and federal taxation. It is often suggested that such tax benefits act as a strong inducement for the organization of activities along nonprofit rather than for-profit lines.<sup>125</sup> Although there is undoubtedly some truth to this, tax considerations are probably far less important than is commonly thought.

#### 1. *Tax Exemption*

A large class of nonprofit organizations is exempt from the federal income tax. Not all nonprofits are exempt, however; rather, exemption extends only to those serving a specified, though broad and ill-defined, set of purposes.<sup>126</sup> For example, while nonprofit hospitals and educational institutions are exempt, automobile service clubs are not.<sup>127</sup>

124. See pp. 862-72 *supra*.

125. E.g., Schoenfeld, *Federal Taxation and Non-Profit Organizations*, 19 CLEV. ST. L. REV. 290 (1970).

126. See, e.g., note 107 *supra*.

127. See *Chattanooga Auto. Club v. Commissioner*, 182 F.2d 551 (6th Cir. 1950); G.C.M. 23688, 1943 C.B. 283, as modified by Rev. Rul. 69-635, 1969-2 C.B. 126.

Whether this exemption has had a meaningful impact on the types of activities undertaken by nonprofits is questionable. To begin with, by the time the corporate income tax first appeared in the late nineteenth century, nonprofit organizations already were well established in many of the areas where they are found today. Furthermore, the tax liability of many nonprofits under the corporate tax would probably be modest even if they were not exempt.<sup>128</sup> Finally, and perhaps most important, over time the definition of the categories of nonprofits that qualify for exemption has followed the expansion of nonprofits into new fields, rather than vice versa. The tax code did not set forth in the beginning a well-defined set of sectors in which nonprofits could qualify for exemption, generating nonprofits in those sectors. Instead, as nonprofits have moved into new types of activities, the tax code has been reinterpreted or amended to permit nonprofits undertaking those activities to qualify for exemption. The performing arts, nursing care, and hospital care, for example, reflect this pattern of development.<sup>129</sup>

The exemption of most nonprofit institutions from state and local real property taxes is probably of greater financial significance to the organizations than is the exemption from the corporate income tax. Furthermore, property taxes, and the nonprofit exemption from them, significantly antedate the federal income tax.<sup>130</sup> Yet here as well, the exemption seems to have followed the pattern of nonprofit development rather than vice versa.<sup>131</sup>

In any case the current pattern of nonprofit development is strong

128. Although defining taxable income for nonprofits would require the development of a variety of new accounting conventions, see Bittker & Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299, 307-14 (1976) (suggesting problems in defining taxable income for nonprofits), even a broad definition would not be likely to burden most nonprofits with substantial tax liabilities.

129. Nonprofit performing arts organizations have been granted exemptions under I.R.C. § 501(c)(3) as "educational" entities. See Treas. Reg. § 1.501(c)(3)-1(d)(3)(ii), example (4) (1959); Rev. Rul. 64-175, 1964-1 C.B. 185. Nonprofit nursing homes, even if they are commercial in the sense I have defined above, have been granted exemptions as "charitable" organizations. See Rev. Rul. 72-124, 1972-1 C.B. 145. Nonprofit hospitals for many years qualified for exemption as "charitable" institutions only if they provided free or below-cost care to the poor; now that most nonprofit hospitals provide no meaningful amount of such subsidized care, however, the definition of "charitable" for federal tax purposes has been revised so that even a strictly commercial nonprofit hospital qualifies for exemption. See Rev. Rul. 69-545, 1969-2 C.B. 117; *Eastern Ky. Welfare Rights Organization v. Simon*, 506 F.2d 1278, 1288-89 (D.C. Cir. 1974), *rev'd on other grounds*, 426 U.S. 26 (1976) (upholding Revenue Ruling on grounds that concept of "charity" should be redefined to reflect change in nature of nonprofit hospitals).

130. See *Walz v. Tax Comm'n*, 397 U.S. 664, 676-78 (1970); A. BALK, *THE FREE LIST* 20-27 (1971).

131. However, some states have been more liberal than others in granting exemptions. See A. BALK, *supra* note 130, at 73-86; Note, *Exemption of Educational, Philanthropic and Religious Institutions from State Real Property Taxes*, 64 HARV. L. REV. 288 (1950).



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evidence that the availability of an exemption is not the decisive factor in determining whether a given activity will be organized along nonprofit lines. There are many fields, such as nursing care, in which nonprofits qualify for tax exemption but have not come to dominate the industry.<sup>132</sup> Conversely, nonprofits continue to be the dominant form of organization among automobile service clubs, which constitute what appears to be the only substantial class of nonprofit organizations for which a federal income tax exemption has been explicitly denied.<sup>133</sup>

On the other hand, tax exemption obviously gives nonprofit organizations a competitive advantage that they would not otherwise enjoy with respect to for-profit firms, and thus probably influences the overall extent of nonprofit development even if it is not important in determining the industries in which that development takes place.

### 2. *The Charitable Deduction*

An individual who contributes to a nonprofit organization can often deduct his donation from his income in determining his personal federal income tax. Whether the contribution is deductible depends upon whether the donee organization falls within a class of nonprofit organizations defined by the Internal Revenue Code, a class that is a subset of the class of nonprofits that qualify for exemption from the corporate income tax.<sup>134</sup>

The availability of this charitable deduction provision obviously gives a financial advantage to those nonprofits that qualify for it.<sup>135</sup> Yet, as in the case of the exemption of nonprofits from taxation, the charitable deduction probably has had more of an impact upon the overall scale of nonprofit activity than upon its distribution. First, as in the case of exemption, the charitable deduction has been expanded over time to follow the entry of nonprofits into new fields, rather than vice versa. With the exception of organizations formed to affect the political process, nearly all nonprofits that receive a substantial amount of their income from donations qualify for the charitable deduction.

Second, the availability of the charitable deduction has proven neither necessary nor sufficient for the development of donative non-

132. See notes 81, 129 *supra*.

133. See note 127 *supra*.

134. I.R.C. § 170. Similarly defined deductions are available under the federal estate and gift taxes. *Id.* §§ 2055(a), 2522(a).

135. Recent empirical studies indicate that elimination of the charitable deduction would lead to a significant decrease in donations to nonprofit institutions, though the impact would vary from one type of institution to another. See Feldstein, *The Income Tax and Charitable Contributions* (pts. 1 & 2), 28 NAT'L TAX J. 81-100, 209-26 (1975).

profits. Organizations qualifying for the charitable deduction are not always able to attract donations. Indeed, there are many commercial nonprofits, such as hospitals and nursing homes, that qualify for the deduction and would welcome donations, but that have never been able to attract them in meaningful amounts or have only been able to attract them from organizations, such as governments or other exempt nonprofits, for which the deduction has no value. Conversely, donative nonprofits such as political organizations thrive even when the gifts that support them fail to qualify for the deduction.

#### D. *Historical Factors*

The analysis of the role of nonprofit organizations developed here is essentially static and ahistorical, in that it views the existing distribution of nonprofits across industries as a functional response to certain contemporary economic conditions rather than as the ultimate product of a long process of historical development. To some, such an approach may seem short-sighted: surely the current distribution of nonprofit organizations, which have been a feature of Anglo-American law for nearly a millennium, reflect a variety of historical developments.

Undoubtedly nonprofits arose in the past in some industries in response to conditions that existed at the time but are no longer present. The nonprofit form may have been perpetuated in some of these industries simply through institutional inertia. I already have suggested that to some extent this may be the case in the hospital industry.<sup>136</sup> Yet the hand of the past seems to lie less heavily upon the nonprofit sector than might at first be imagined. In the private sector of a market economy such as ours, market selection seems to work with at least a certain crude efficiency. Nonprofits will tend to be displaced in those industries in which they do not continue to have a functional advantage. Even in the exceptional case of the hospital industry, as I have noted above, the conditions that have made nonprofits in some degree anachronistic developed in full only recently, with the establishment of Medicaid and Medicare in the mid-1960's. Yet already that industry has experienced a substantial influx of large for-profit corporations, which began only two years after these federal programs took effect.

#### VII. Other Forms of Limited-Profit Enterprise

The nondistribution constraint that characterizes the nonprofit form is not the only device available by which a limit can be placed upon the

136. See pp. 866-68 *supra*.

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amount of an organization's income that is diverted to those who control it. There are several other common forms of enterprise that are subject to various types of legal or contractual constraints upon their ability to distribute earnings. The roles performed by these latter organizations offer instructive comparisons with the role of nonprofits.

### A. *Rate-of-Return Regulation*

Public utilities commonly are organized as private profit-seeking firms subject to governmentally imposed price regulation. Under such regulation, prices are restricted to a level that permits the firm's shareholders to earn no more than a specified percentage rate of return on their investment. This rate of return is calculated to be just high enough to render the firm attractive to investors.

In a sense, firms subject to rate-of-return regulation are simply special cases of nonprofit enterprise. That is, they operate under legal constraints explicitly designed to prevent those who control the firm from distributing to themselves amounts in excess of reasonable compensation for services and capital contributed to the firm. The difference between such regulated firms and nonprofit corporations lies primarily in the point at which the profit constraint is applied. Like other profit-seeking corporations, firms subject to rate regulation issue variable-return securities to contributors of capital, who have formal control over the firm. Furthermore, the owners can distribute to themselves, as return on their securities, all of the firm's net earnings, even if those earnings are higher than that necessary to provide a reasonable return on capital. The only constraint to which the owners are directly subject is that applied to prices—although, to be sure, those price limitations are designed to produce a level of net earnings that will allow only a predetermined, reasonable level of return. In the case of nonprofits, on the other hand, the limitation on distribution of earnings is applied directly. Returns to contributors of capital generally either must be at a fixed rate, as with a bond or bank loan, or, if variable, must be subject to an upper bound, as with preferred stock.<sup>137</sup>

If demand for a firm's services and the costs of producing those services were perfectly predictable beforehand, then these two approaches to regulating profit-taking would be equivalent. In fact, however, such predictability is rare; thus these approaches have come to be applied in distinctly different circumstances.

137. Both New York and Pennsylvania, for example, provide for capital "subventions," which are analogous to preferred stock. See N.Y. NOT-FOR-PROFIT CORP. LAW § 504 (McKinney 1970); PA. STAT. ANN. tit. 15 App., § 7542 (Purdon 1977).

Rate-of-return regulation based on price ceilings typically has been applied only to public utilities, such as gas, water, electricity, and telephone companies. These utilities share several characteristics in common: they are natural monopolies; they are capital-intensive; the service they provide is relatively homogeneous; and the cost and demand schedules for their services are reasonably predictable. In all of these respects they differ from most services provided by nonprofits. And it is these characteristics that determine whether a profit constraint focused on prices or one focused on distribution of earnings is more appropriate.

The primary problem presented by a monopoly is that it is likely to set its price too high. Thus price is the logical focus for regulation. A constraint that applies to distribution of earnings provides only an indirect route to price control. Furthermore, a constraint applied directly to the rate of return allowed to capital would eliminate virtually all incentives for cost reduction. As it is, if a public utility manages to reduce its costs more than was predicted when rates were last set, its owners can enjoy extra profits during the lag preceding a new round of rate-setting. On the other hand, for most services provided by nonprofits, regulation is intended primarily to eliminate incentives to engage in excessive cost-cutting. The simplicity and homogeneity of the services provided by utilities make it relatively easy to determine when a utility has engaged in excessive cost-cutting by reducing the quality of its service. But for most nonprofits, the problem arises precisely because of the difficulty of making such a determination. The simplicity and homogeneity of services rendered by public utilities also make it relatively easy to establish a price schedule. For most nonprofits, on the other hand, price schedules would be impossibly complex.<sup>138</sup>

The fact that public utilities are monopolies also ensures that a firm will receive the maximum price set by the regulatory authorities. Most nonprofits, however, compete with other firms providing similar services; as a consequence, one cannot predict with much certainty how

138. With electricity, for example, it is only necessary to establish a unit price for a single, simple commodity that is easily metered: a kilowatt-hour of alternating current electricity supplied at a given voltage and number of cycles per second, with stated tolerances for variation in the latter parameters. With nursing care, on the other hand, even for such basic matters as meals, it would be necessary to specify in great detail, for each alternative price level, the minimum quantity and quality of food that must be served, including all the criteria of nutrition, palatability, and variety that an individual would apply in selecting a restaurant that is to be patronized on a regular basis. And the same would be necessary for room charges, nursing services, and so forth.

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great demand for a given firm's service will be in the future at any given price, particularly given the imperfect nature of the competition. Thus simply setting a price ceiling will not ensure that the firm receives neither too much nor too little income to cover its costs.

Finally, because public utilities are capital-intensive, they need a dependable supply of capital. Thus a system of regulation that is biased, if at all, toward the interests of investors seems appropriate. The services provided by nonprofits, on the other hand, are generally labor-intensive, and consequently a system of regulation that discourages variable-return securities and investor control, and therefore makes it difficult to attract venture capital, is less of a liability.

### B. *Limited Dividend Companies*

In recent years the federal government has authorized "limited dividend" companies, typically partnerships, to invest in federally subsidized housing projects. Such entities are restricted, under a contract with the Federal Housing Administration, to a maximum rate of cash return on equity.<sup>139</sup> Since with these organizations the restraint on profits is applied directly to distributions and not to the price that the organizations charge for their services, they are even closer in form to nonprofits than the regulated utilities just discussed.<sup>140</sup>

Such organizations fill much the same role as donative nonprofits. In fact, sponsorship of federally subsidized housing in general is largely confined to organizations formed as private nonprofits, state agencies, or limited dividend companies. The government has stipulated the limitations on profits to ensure that its subsidies are passed through to the ultimate consumers of the housing that the firm produces. Presumably the government permits limited dividend companies to participate in subsidized housing programs because they are a better device than nonprofits for attracting private investment capital. This can be true only if the effective rate of return on an investment in such a company, including tax benefits, is above the amount that nonprofits generally can give to contributors of capital. Nonprofits are subject to limitations that make it difficult to provide adequate compensation to capital contributed at risk. The difficulties created are not too severe in the labor-intensive areas where nonprofits are most often formed

139. See D. FALK & H. FRANKLIN, *EQUAL HOUSING OPPORTUNITY* 38-43 (1976).

140. Sometimes the rate-of-return limitation is imposed on limited dividend companies not by contract, but by the state statute under which they are formed—just as in the case of nonprofits. See *New Jersey Limited-Dividend Housing Corporations Law*, N.J. STAT. ANN. § 55:16-5 (West 1964).

and are outweighed by the high degree of fiduciary accountability that such tight limitations ensure. In a capital-intensive enterprise such as housing, however, such severe limitations on compensation for investors may be too much of a handicap and may not be necessary to police the firm's performance, since the government can insist relatively easily upon detailed and accurate financial reporting. Thus, it makes sense to create for such purposes a new class of organizations subject to restrictions on the distribution of earnings that are somewhat less restrictive than those applied to ordinary nonprofits.

### C. *Cost-Plus Contracting*

When services are desired from a profit-seeking firm, but the cost of providing those services cannot easily be determined in advance, the "cost-plus" form of contract has become common. The government, for example, frequently uses cost-plus contracts in procuring research and development work from private firms. Such contracts typically provide that the firm will receive payment to cover all of its allocable expenses plus, say, ten percent profit.

The cost-plus contract places much the same type of limitation upon a firm as does the nonprofit form. In each case the firm is obliged to devote a specified fraction of the consumer's payment to production of the service. A distinction between the two, on the other hand, is that the cost-plus contract applies only to a given transaction, while the restrictions involved in the nonprofit form extend to all of the firm's transactions.

There are, however, significant distinctions between industries characterized by cost-plus contracting and those characterized by nonprofit firms. If a cost-plus contract is to provide a consumer with significant protection, he must be able to evaluate intelligently the supplier's statement of expenses in order to prevent the supplier from extracting more than the specified profit. In fact, such contracts are probably used primarily not to protect the consumer, but rather to protect the supplier from the burden of unexpected costs, by transferring risk from the supplier to the purchaser.

A nonprofit supplier, in contrast, is better suited to the situation in which the consumer cannot evaluate either the quality of the services produced or the use of inputs to produce the service. This is especially likely to be a problem when the individual transaction is small relative to the size of the firm, so that the firm's costs are not easily allocated to the performance of particular services, as for example, with colleges and hospitals. Cost-plus contracting, on the other hand, is most com-

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monly found where the transaction is relatively large and the firm can account separately for the inputs required to perform the job.

### D. *Cooperatives*

As noted earlier, cooperative corporation statutes typically give cooperatives the right to distribute net earnings to both patrons and contributors of capital.<sup>141</sup> Moreover, the statutes generally provide that either or both of these groups can be given control of the organization.<sup>142</sup> Yet the statutes also commonly place a limit upon the amount of earnings that can be distributed to contributors of capital, restricting them to some maximum rate of return on the amount invested.<sup>143</sup> Distributions to patrons are unlimited, but generally must be proportionate to each individual's patronage.<sup>144</sup>

In sum, the typical cooperative is a limited-profit enterprise so far as investors of capital are concerned; earnings in excess of the amounts distributable to investors must be reinvested or returned to patrons. Thus cooperatives bear a certain resemblance, on the one hand, to nonprofits, and, on the other hand, to regulated-rate-of-return organizations such as public utilities. The economic role performed by cooperatives, however, is closer to that of regulated firms than to that of nonprofits. That is, cooperatives often appear to be established primarily to limit the price charged to the consumer. Typically they are formed when the consumer would otherwise face a monopolist, as in the case of public utilities, or services—such as retailing and grain storage—provided to rural communities that are too small to support enough suppliers to assure effective competition. In contrast to the role of nonprofits, the consumer's inability to judge the quality of service is generally unimportant in the formation of cooperatives. In fact, cooperatives frequently provide standardized services, such as retailing food and merchandise or producing and distributing electricity.<sup>145</sup>

Such a difference in the functions performed by cooperatives and nonprofits in fact makes considerable sense. If the motivation for form-

141. *E.g.*, WIS. STAT. ANN. § 185.45 (West 1957) (a representative, though unusually carefully drafted, statute).

142. *E.g.*, *id.* § 185.11.

143. *E.g.*, *id.* § 185.21(1)(c) (limiting stock dividends to 6% of par value).

144. *E.g.*, *id.* § 185.45(3)(b).

145. The difference between the economic role of nonprofits and that of cooperatives should not, however, be exaggerated. In a sense, both forms are devices to protect consumers from exploitation in circumstances in which ordinary for-profit producers would have excessive market power. Where cooperatives are found, that market power typically derives from the absence of competing firms; where nonprofits are found, it typically derives from an asymmetry of information between the producer and the consumer.

ing the enterprise is to avoid excessive prices for standardized goods, then it is convenient to have a mechanism whereby any amounts paid beyond those necessary to compensate for the services rendered can be returned to the consumers, as they can be in the case of cooperatives. Where, on the other hand, the consumer's primary fear is that insufficient resources will be devoted to maintaining the quality of the services rendered, it makes sense to structure the organization in the nonprofit form so that all amounts received must be devoted to the production of services, thus eliminating the incentive to cut corners.<sup>146</sup>

### VIII. Mutual Nonprofits

I suggested earlier that nonprofits can be classified as either mutual or entrepreneurial, depending upon whether or not they are controlled by their patrons. We are now in a position to explore some of the considerations that might lead to the formation of a mutual nonprofit as opposed to, on the one hand, an entrepreneurial nonprofit, or, on the other hand, a cooperative.

#### A. *Mutual Versus Entrepreneurial Nonprofits*

Several motivations for choosing the mutual rather than the entrepreneurial form of management for a nonprofit are apparent. First, and most important, it gives the patron more control over the use made of his funds. Since, as I have been arguing, nonprofits are particularly likely to arise in just those situations in which the impersonal mechanisms of the market are unable to provide adequate protection for the consumer, some degree of direct control over the organization may be

146. Unfortunately, nonprofits and cooperatives are not always carefully distinguished. The Illinois nonprofit corporation statute, for example, includes among the limited purposes for which a nonprofit corporation may be formed such things as "electrification on a cooperative basis" and "telephone service on a mutual or cooperative basis." ILL. ANN. STAT. ch. 32, § 163a3 (Smith-Hurd Supp. 1978).

Confusion of this sort can have the undesirable consequence of vitiating the nonprofit form. If cooperatives are allowed to form under the nonprofit statutes, then the nondistribution constraint must be loosened somewhat for these organizations; as a consequence of the confusion between the two forms, such a relaxation of the constraint may not be confined just to those organizations for which it is appropriate. For example, evidently seeking to meet the needs of cooperative-type organizations, the authors of the Model Nonprofit Corporation Act have made explicit provision for *any* nonprofit to distribute its assets to its "members" upon dissolution. ALI-ABA MODEL NONPROFIT CORPORATION ACT § 46(d) (1964). Indeed, the Model Act seems to place no meaningful limits whatsoever upon the distribution of assets in a voluntary dissolution. *See id.* § 46(e). (The provisions concerning distribution of assets have been adopted verbatim in the Illinois statute referred to above. ILL. ANN. STAT. ch. 32, § 163a44 (Smith-Hurd 1970).) Such a gaping hole in the nondistribution constraint is obviously inappropriate for true nonprofits.



especially desirable. For example, parents can be expected to feel a stronger desire for direct representation on the board of the day care center that cares for their child than on the board of the market that provides the family's food, or the store that sells them their child's clothes.

Second, when consumers are also members of the organization it may be easier to coax them into providing enough funds to keep it going. This may be an especially strong consideration where the organization relies at least in part on donations. Thus, one motivation for keeping the membership of a church relatively well defined is undoubtedly so that the members can be approached, and made to feel responsible, for contributions beyond those made during services or in the form of unsolicited gifts.

Finally, there appears to be a third reason for adopting the mutual form that is somewhat divorced from the considerations that have been the focus of the discussion so far: the running of an organization may itself be a consumption item of value to the organization's supporters. The primary motivation for fraternal lodges, for example, is probably just the camaraderie and diversion involved in keeping them going; the ends ostensibly served by such organizations often seem to be little more than an excuse for setting them up.<sup>147</sup>

There are, on the other hand, many cases in which the mutual form, despite its advantages, seems impractical. It requires, to begin with, a certain commitment of time and energy on the part of the organization's patrons, and often they are likely to feel that their stake in the organization is insufficient to merit such effort. This is especially likely to be the case if the patrons are geographically dispersed, or if their individual transactions with the organization are quite small. Furthermore, in some cases, as with hospitals, the patron is likely to use the organization's services only sporadically, and consequently will probably feel little incentive to take a continuing interest in its affairs.

### B. *Mutual Nonprofits Versus Cooperatives*

#### 1. *In General*

I have already remarked that the factors that lead to the formation of cooperatives appear to be rather different from those that lead to the

147. Among religious organizations the choice of the mutual or the entrepreneurial form may be dictated by doctrinal considerations. Thus the Roman Catholic Church, like other churches in which authority is episcopal, is an entrepreneurial nonprofit, while churches in which the ultimate authority is seated in the congregation, as among Congregationalists and Baptists, take the form of mutual nonprofits.

formation of nonprofits. In general, this conclusion applies as well to nonprofits that are mutual as to those that are entrepreneurial. For example, it is not obvious that such mutual nonprofits as the Sierra Club or the National Audubon Society occupy positions of natural monopoly; rather, they are evidently nonprofit in response to the same problems of contract failure described earlier for other donative organizations.

## 2. *An Exception to the Contract Failure Theory: Social Clubs and Other Exclusive Organizations*

In some interesting and important cases, however, it appears that mutual nonprofits have in fact formed for the same reasons that commonly underlie the development of cooperatives—namely to counter monopoly—rather than for the reasons of contract failure that underlie the formation of other nonprofits. Consider, for example, country clubs, which are commonly organized as nonprofits. The services that such clubs provide to their members—such as food, drink, and athletic facilities—do not seem to be such that the consumer is at any particular disadvantage in shopping for them in a competitive market. In fact, the same or similar services are commonly provided in other contexts by profit-seeking firms, such as restaurants, hotels, and resorts. Why, then, are country clubs not generally run by profit-seeking entrepreneurs?

The answer seems to derive in large part from the social exclusivity that characterizes most country clubs. Typically, membership in a club is not open to everyone who is willing to pay the dues. Rather, to become a member an applicant usually must also be socially acceptable to the other members. Such exclusivity assures that the club's members will exhibit at least a minimal set of those personal qualities considered attractive by the other members. In fact the opportunity to associate with people who exhibit these qualities is one of the principal attractions of joining a club—sometimes much more important than the actual services that the club provides.

The desire to maintain such exclusivity does not in itself necessitate that a club be nonprofit. Profit-seeking organizations are also perfectly capable of choosing their customers on social criteria.<sup>148</sup> Rather, the

148. To take an obvious example, until the recent past it was quite common for profit-seeking hotels, resorts, and restaurants to decline to serve blacks or Jews. To be sure, nonprofit clubs today have somewhat more freedom under the law to discriminate on the basis of race, religion, and sex than do profit-seeking firms. See Note, *Discrimination in Private Social Clubs: Freedom of Association and Right to Privacy*, 1970 DUKE L.J. 1181,

incentive to form a club as a mutual nonprofit rather than as a for-profit firm seems to derive primarily from the monopoly power that accrues to a highly exclusive club. Since I have explored this phenomenon in detail elsewhere,<sup>149</sup> I shall give only a brief sketch of it here.

A system of exclusive clubs has a natural tendency to become stratified, so that the highest-status individuals gather together in one club, the next-highest stratum of individuals in another club, and so forth. Indeed, such a pattern is fairly easy to discern among the clubs found in many communities. Since most people would prefer to be in the most exclusive clubs, those clubs have a degree of monopoly power. A profit-seeking owner of a highly exclusive club would have every incentive to use this power to exploit his own members—for example, by means of membership dues well in excess of costs. In effect, he would be selling the members their own high status at a monopoly profit.

To avoid such exploitation, the members have a strong incentive to organize the club as a cooperative. Why do they generally form a mutual nonprofit rather than a cooperative? Perhaps because the nonprofit form is just as well suited to their needs—since there is no particular need to distribute dividends—and in some cases also brings with it various tax benefits.<sup>150</sup> Moreover, many states do not include social clubs among the purposes for which a cooperative corporation may be formed, typically confining the latter to, for example, agricultural pursuits.<sup>151</sup> This in turn reflects the peculiar evolution of cooperative enterprise in this country,<sup>152</sup> which may in itself have led cooperatives to be associated in the popular mind only with rather particular activities and circumstances, none of which encompass social clubs. In the case of social clubs, then, nonprofit firms appear to have developed

1184. Yet other social criteria for admission remain unregulated. And in any case, the application of antidiscrimination laws to private organizations is a development only of the past decade or so, long after nonprofit social clubs became common.

Further evidence that for-profit firms are capable of being quite exclusive can be found among English men's clubs, some of the more prominent of which were proprietary even at the height of their fashionability. See Chafee, *The Internal Affairs of Organizations Not for Profit*, 43 HARV. L. REV. 993, 1000 (1930).

149. Hansmann, *Externalities, Exclusivity, Stratification, and Cooperation: A Theory of Associative Organizations* (Working Paper No. 807, Institution for Social and Policy Studies, Yale University (1978)).

150. The essential difference under the federal income tax is that income from members retained for working capital or expansion of the organization's facilities is taxable if it is organized as a cooperative, I.R.C. §§ 1381-1388, but not if it is organized as a nonprofit, *id.* § 501(c)(7). See Bittker & Rahdert, *supra* note 128, at 348-53.

151. For example, Indiana law provides only for the formation of cooperatives for agricultural purposes, see IND. CODE ANN. § 15-7-1-4 (Burns 1973).

152. For an overview of the development of the cooperative movement in the United States, see Margolis, *Coming Together—The Cooperative Way: Its Origins, Development & Prospects*, THE NEW LEADER, April 17, 1972 (special issue).

as a consequence of a rather different type of market failure than that which has been the principal focus of this essay. Thus social clubs seemingly constitute the single major exception to the contract failure theory of nonprofits that has been the primary focus of this Article.

This is not to say, however, that this set of factors is entirely confined to social clubs. Similar tendencies toward exclusivity and stratification are to be found, for example, among hospital medical staffs, university faculties, and the student bodies of educational institutions of all types. In all these cases, the resulting incentives for cooperative control may be a contributing factor, though probably not the decisive factor, in leading the institutions involved to adopt and maintain the non-profit rather than the for-profit form.<sup>153</sup>

## IX. Nonprofit Versus Governmental Organization

The discussion so far has focused almost entirely upon a comparison of nonprofit and for-profit organizations. The recurrent issue has been the determination of the factors that make one of these forms of enterprise more viable than the other in any given circumstance. In putting the issue this way, however, I have largely ignored a third important alternative: governmental enterprise.

A number of services commonly provided by nonprofit organizations are also frequently undertaken by government. Education, hospital care, libraries, and aid to the poor are obvious examples. Indeed, historically the public sector has tended to absorb activities that were originally undertaken by private nonprofits.<sup>154</sup> Let us briefly consider, then, why a particular service is provided by nonprofits rather than by governmental institutions.<sup>155</sup>

### A. *Advantages of Governmental Organization*

In the provision of public goods, the taxing power of government gives it a strong advantage over nonprofits. As discussed above, nonprofit suppliers of public goods are likely to have difficulty in securing contributions as a consequence of the incentive for individuals to be free riders; this problem is mitigated by funding through taxation. However, governmental organizations do not limit themselves to supplying public goods and services. Hospital care and post-secondary educa-

153. See Hansmann, *supra* note 149.

154. J. DAVIS, *supra* note 32; D. OWEN, *ENGLISH PHILANTHROPY, 1660-1960* (1964).

155. See Nelson & Krashinsky, *supra* note 2.

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tion are examples of primarily private services commonly provided by government. In such cases, governmental organization has an advantage over commercial nonprofits in assuring more dependable access to capital. Furthermore, when the alternative to governmental organization is an entrepreneurial nonprofit rather than a mutual nonprofit, the governmental form has the additional advantage of providing some accountability, if not to its immediate patrons then at least to the public.

### B. *Advantages of Nonprofit Organizations*

On the other hand, governmental provision of a public or private service may be inappropriate or infeasible if the service is desired by only a small portion of the populace or if the distribution of individuals' demand for the service bears no relation to the incidence of the taxes that would be used to support it. Private nonprofits can be structured more easily to serve a narrow patronage.<sup>156</sup> Nonprofit organizations also may be considerably more responsive to the needs of those they serve than are governmental organizations. Both nonprofits and governmental entities can be designed to respond, to a greater or lesser degree, to influence exercised by patrons through such nonmarket means as political pressure, complaints, and in the case of mutual nonprofits and some governmental organizations, direct voting control. Nonprofits, however, whether commercial or mutual, have the advantage that they generally leave much more scope for market discipline through access to competing producers; when governmental provision of a service develops, choice among alternative suppliers is often considerably reduced, if not entirely eliminated. Moreover, in order to assure that governmental enterprise will be accountable, a chain of authority must be developed that links each individual service organization with the central executive and legislative authority of the government; the resulting bureaucracy may be sluggish and disproportionately costly, particularly if there are no substantial economies of scale involved in managing such enterprise, as there often are not with the kinds of services provided by nonprofits.

156. For example, if governmental provision of a public good is supported by broad-based taxes, and if the government is controlled by majority vote among the taxpayers, then the public good will tend to be supplied at the level that satisfies the desires of the median voter. This will leave unsatisfied those citizens whose demand for the public good exceeds that of the median voter, and their only recourse may be to seek to obtain additional amounts of the public good through nongovernmental means—such as a donative nonprofit. *See* B. WEISBROD, *supra* note 2.

### C. *Further Considerations*

A comparison of the roles of nonprofit and governmental organizations, from both a descriptive and a normative viewpoint, deserves much closer treatment than I have given it here. I have chosen to focus primarily upon a comparison of nonprofit with for-profit, rather than with governmental, enterprise simply because this approach offers the most direct means of illustrating essential functions served by nonprofits, and because it is the most instructive for analyzing and evaluating the existing legal framework for nonprofit enterprise. This approach also benefits from the extensive theoretical and empirical work that has already been done concerning profit-seeking enterprise; a full comparison of nonprofit and governmental organizations must await a more refined understanding of the role and performance of the governmental sector.

### X. Law, Economics, and Individual Behavior

In this Article I have offered, in essence, a positive theory of consumer demand. That is, I have argued that nonprofits tend to produce particular services, those characterized by "contract failure," because consumers prefer to deal with nonprofits in purchasing those services. This preference, I have suggested, is based upon a feeling that nonprofits can be trusted not to exploit the advantage over the consumer resulting from contract failure. This trust derives its rational basis from the nondistribution constraint that characterizes the nonprofit form.

One might object that consumers do not, in fact, think this way. Surely the average consumer, if asked why he deals with a nonprofit rather than a for-profit firm in a given situation, would be unlikely to elaborate the theory of contract failure offered above. Indeed, one suspects that most people are vague about precisely what it is, from a legal point of view, that makes an organization nonprofit.

The theory outlined in this Article, however, does not require that every consumer, in choosing whether to deal with a nonprofit organization, perform an elaborate cost-benefit analysis concerning the type and degree of market failure involved, the effectiveness of the nondistribution constraint, possible offsetting inefficiencies of the nonprofit form, and so forth. Rather, it is sufficient that experience in the longrun leads consumers as an overall group to develop a sense that in certain circumstances it is most appropriate to deal with nonprofits. Undoubtedly for most consumers such attitudes are learned from others rather than based upon conscious reflection. I am suggesting only that for those

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consumers who do exercise independent judgment, the decision to patronize a nonprofit versus a for-profit firm is based either upon some previous experience with both nonprofit and for-profit firms in various circumstances, or upon a more or less conscious realization that in purchasing the service one is to some degree at the mercy of the producer, and that therefore one may be better served by a firm in which the profit motive has been curtailed. Similarly, the arguments advanced in the preceding sections do not lose force merely because many individuals who patronize nonprofits have at best only a vague understanding of the nondistribution constraint. It suffices that some subset of patrons has a general notion that when an organization is nonprofit it is somehow committed to operating for some purpose other than profit maximization. In general, social institutions and patterns of behavior may represent a reasonable degree of economic rationality even when most of the individuals involved are not self-consciously engaged in intricate processes of economically rational thought. Although I do not wish to align myself with all those who find an extraordinary level of economic efficiency reflected in various broad areas of legal doctrine,<sup>157</sup> I do believe that there is, not surprisingly, an inherent, if crude, logic to many of our social institutions, including nonprofit institutions.

I do not, of course, pretend to have explained here everything important that there is to know about the nonprofit sector. For one thing, it takes supply as well as demand to make a market; to understand the nonprofit sector in full, one must know not only the circumstances under which patrons will seek the services of nonprofits, but also the factors that determine whether and how nonprofit organizations will develop to meet that demand. In this Article I have focused heavily on the demand side, primarily because this seems the best way to illuminate the general role served by the nonprofit form. Questions of supply response have been touched upon only briefly,<sup>158</sup> and much remains to be said.<sup>159</sup>

Moreover, I have by no means given a complete picture even of the demand side. In particular, I have made little effort here to explore the sources of donative behavior—those factors, for example, that lead

157. See, e.g., Landes & Posner, *Salvors, Finders, Good Samaritans, and Other Rescuers: An Economic Study of Law and Altruism*, 7 J. LEGAL STUD. 83 (1978); Posner, *A Theory of Negligence*, 1 J. LEGAL STUD. 29 (1972).

158. See pp. 873-79 *supra* & appendix, pp. 899-901 *infra*.

159. See Dennis Young, *Human Service Enterprise: Case Studies of Entrepreneurship in Child Welfare* (1980) (unpublished manuscript) (studies of personal motivations and other factors influencing individuals who act as entrepreneurs in nonprofit sector).

an individual to contribute voluntarily toward the financing of a public good, or to repay voluntarily the implicit loan he received from his undergraduate college.<sup>160</sup> Rather, I have taken such behavior for granted and have simply asked: given that people are prepared to donate in such circumstances, what is the structure of the organizations to or through which they will choose to direct their contributions?

### Conclusion

There is a tendency to view nonprofit organizations as institutions that defy systematic, and particularly economic, analysis—because either, on the one hand, they are thought to be the product of arbitrary historical processes, or, on the other hand, they are thought to be invested with an ethical quality that places them beyond mere utilitarian concerns. I have suggested here, instead, that we should view the nonprofit organization as a reasonable response to a relatively well-defined set of social needs that can be described in economic terms. It follows that it is the responsibility of lawmakers to review and reform the hodge-podge of organizational and regulatory law that applies to nonprofits to ensure that it is well-designed to assist nonprofits in serving those needs. The ideas advanced here will, I hope, serve as a useful guide in that process.

160. Economic models commonly assume that individuals act in an “economically rational” manner in that they choose to engage only in those activities that promise to yield benefits to the individual that exceed their costs. Such an assumption, simplistically applied, might lead one to conclude that individuals will seldom undertake activities, such as voluntary support for public goods, for which the costs far exceed the direct material benefits to the individual, and to label such behavior as “economically irrational” when it is observed. Yet in fact, such altruistic or socially cooperative behavior is extremely common, and, once we change our unit of analysis from the individual to the society as a whole, it typically represents a very high level of economic rationality. See pp. 848-54, 859-62 *supra*; B. WEISBROD, *supra* note 2, at 65-66. For further examples of the economic efficiency of altruistic behavior, see Posner, *A Theory of Primitive Society, With Special Reference to Law* (Working Paper No. 007, Center for the Study of the Economy and the State, University of Chicago (1979)).

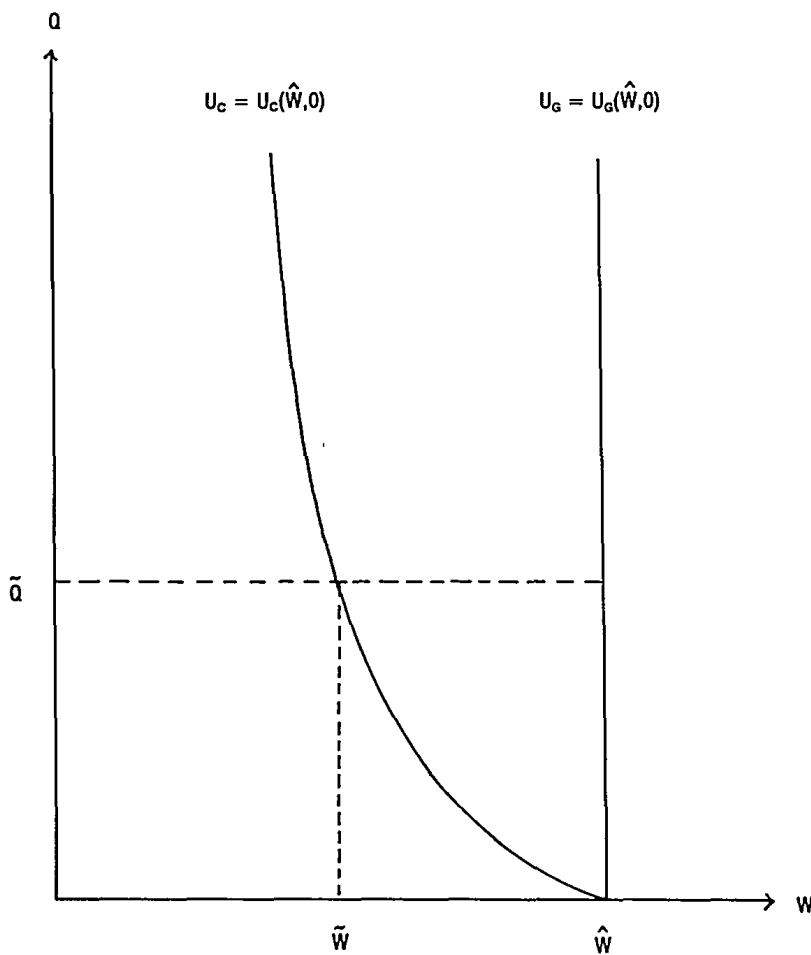


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## Appendix: Signaling and Screening

Let us assume that there are two types of people who are potential managers or entrepreneurs in a given service industry. The first type is interested only in money and will pursue whatever vocation pays the most. These I shall term "greedy" and refer to henceforth as "G's." The second type is interested not only in money, but also in the quality of service produced by the institutions they manage. That is, they take positive satisfaction in operating a high-quality institution. These individuals I shall term "craftsmanlike" and refer to as "C's."

Both C's and G's, let us further assume, have roughly equal opportunities in other sectors, where they could both receive a return  $\hat{W}$  for their services. If a G is to work in the service industry in question, therefore, he must receive compensation at least equal to  $\hat{W}$ . But a C might be willing to work in this service industry at a level of compensation less than  $\hat{W}$  if the institution involved provides relatively high-quality service. The situation is diagrammed in Figure 1. The vertical axis gives the quality of service provided by the service organization, while the horizontal axis gives the level of compensation received by its manager. The lines labeled  $U_c = U_c(\hat{W}, 0)$



and  $U_c = U_c(\hat{W}, O)$  give the locus of  $(W, Q)$  combinations that represents the minimum necessary to attract a G or a C, respectively, to undertake the organization's management. For example, if the organization involved offers a service level  $\bar{Q}$ , then a G must receive compensation of at least  $\hat{W}$  to manage the organization, while a C need only be paid  $\bar{W}$ .

If market forces worked effectively, all organizations would be managed by C's, who demand less compensation than G's for any given level of quality. But suppose that in fact consumers are very poor judges of the quality of service that the organizations in question provide. Then it might be possible for a G to set up a firm promising a given level of quality, but in fact providing a lower and less costly quality level and reaping substantial profits for himself.

In such circumstances, consumers might like to have some assurance that the firm they deal with is managed by a C rather than by a G. Such assurance can in fact be provided if the firm is somehow constrained to pay its manager/entrepreneur some amount less than  $\hat{W}$ , for then only a C will take the job. The nonprofit form may serve, in some cases, to place just such a limit on the compensation of the manager/entrepreneur.

To be sure, as we have seen in Part I above, the nonprofit form does not involve any dollar limitation upon the amount that can be distributed to those who control the enterprise. It does in effect, however, limit such individuals to receiving compensation in the form of a salary, and a relatively fixed salary at that. Any form of compensation that varies from year to year, and particularly one that varies according to the annual surplus achieved by the firm, is likely to be viewed as a distribution of profits either by the state authorities charged with policing nonprofit corporations or by the Internal Revenue Service. Yet there is a limit to the level at which a fixed salary can be set in a relatively small firm whose future costs and revenues are not entirely predictable.

Moreover, any fixed salary that is particularly high is likely to be viewed with suspicion in any firm. Entrepreneurs who form for-profit firms commonly take part of their compensation by means of a share in equity. Consequently, the salary portion of their compensation is generally not particularly large. In fact, if an owner/manager does set a high salary for himself he is likely to be challenged by the IRS, who may seek to treat part of the salary as a distribution of profits, which is not deductible for corporate tax purposes, rather than as wages, which are deductible. Yet it is likely to be only the salary portion of a for-profit manager/entrepreneur's compensation that is taken as a norm in determining whether the salary received by the manager/entrepreneur of a nonprofit is excessive.

Let us assume, then, that the manager/entrepreneur of a nonprofit firm can receive compensation no higher than  $\bar{W}$ , where  $\bar{W} < \hat{W}$ , while his counterpart in a for-profit firm faces no formal limit to his total compensation. Two consequences follow immediately from this: first, only C's will become manager/entrepreneurs for nonprofit firms; and second, no nonprofit firm will offer a level of quality below  $\bar{Q}$ , where  $U_c(\bar{W}, Q) = U_c(\bar{W}, O)$  because it will be impossible to attract manager/entrepreneurs for such low levels of  $Q$ .

It seems reasonable to suppose that competition among nonprofit firms, as among for-profit firms, will be insufficient to confine the manager/

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entrepreneurs of nonprofits to the  $(W, Q)$  combinations such that  $U_c(W, Q) = U_c(\bar{W}, 0)$ ,  $Q \geq \bar{Q}$ . Rather, the manager/entrepreneurs could probably manage to secure something close to the maximum compensation  $\bar{W}$  at any level of  $Q$ , and thus could operate at all levels of  $(W, Q)$  such that  $W = \bar{W}$ ,  $Q \geq \bar{Q}$ . Yet even at this a consumer could be certain that, in dealing with a nonprofit firm, he would receive a higher level of quality for the price charged than he would with a for-profit firm.

We would therefore expect that, for all levels of  $Q$  greater than  $\bar{Q}$ , nonprofit firms would dominate the market. Quality levels below  $\bar{Q}$  would have to be provided by profit-seeking firms, however. If the imbalance of information between producers and consumers is in fact severe, then the entire market for quality levels below  $\bar{Q}$  might collapse, so that the service involved would be produced only by nonprofit firms, and only at quality levels of at least  $\bar{Q}$ , or, what is nearly the same thing, quality for all firms in the for-profit sector might end up at some minimal level  $Q^*$ , perhaps well below  $\bar{Q}$ , which is so elemental as to be ascertainable by most consumers;<sup>161</sup> alternatively, there might in fact be a range of quality levels (though still below  $\bar{Q}$ ) offered by for-profit firms, but with a dynamic equilibrium at each quality level characterized by some firms that are quite exploitative and others that are not.<sup>162</sup>

This discussion of the nonprofit form as a screening and signaling device is based on a series of assumptions that may be inaccurate. In a schematic sense, however, it seems to capture a phenomenon that plays some role in the evolution of nonprofit enterprise. Moreover, the pattern of nonprofit and for-profit activity that it predicts—that is, that nonprofits will occupy the high end of the quality spectrum for the service they provide, while profit-seeking firms will serve the low-quality end of the market—characterizes, to a greater or lesser degree, a number of sectors in which nonprofits are found, including professional education, nursing care,<sup>163</sup> and hospital care.<sup>164</sup>

Of course, other factors might also account for a predominance of nonprofits toward the high end of the quality spectrum in any given service industry. One such factor might be the availability of public and private subsidies to nonprofits but not to profit-seeking firms. More detailed case studies than are currently available would be necessary before the importance, in this regard, of the signaling/screening phenomena discussed here could be established.

161. See Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970).

162. See M. Krashinsky, *Day Care and Public Policy* (1973) (unpublished doctoral thesis, Yale University).

163. In 1972, the average total cost per patient-day in nonprofit nursing homes was \$17.71, compared to only \$14.86 for proprietary homes. See DEP'T OF HEALTH, EDUCATION, AND WELFARE, PUB. NO. (HRA) 76-1773, *SELECTED OPERATING AND FINANCIAL CHARACTERISTICS OF NURSING HOMES 3* (1975).

164. The overall accreditation rate for proprietary hospitals has in the past been lower than that for nonprofit hospitals. Although this difference in accreditation rates seems explained in large part by differences in average number of beds, see note 91 *supra*, it is still consistent with the analysis offered here, since manager/entrepreneurs of type "C" might prefer to be associated with the larger, higher-quality institutions—or, put differently, size in hospitals may simply be one aspect of quality.

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