

Some of the contributors to this part review the history and public policy relating to tax exemption and its implications in this era of the trend toward commercialization. While some contributors argue that charitable organizations are acting within the scope of their missions when they charge fees for various activities in the public interest, others argue that the law ought to be changed or that the criteria for determining service in the public interest should be based not on the incorporation status of organizations but rather on their performance.

Underlying many of the arguments in these chapters is the recognition that for-profit organizations have moved into services formerly offered primarily by nonprofits. The debate among the contributors stems from their interpretation of current law or their recommendations to change the law relating to tax exemption. The fundamental issue they are debating is how the public interest ought to be defined. Some argue that tax-exempt status should be narrowly limited to organizations that receive most of their resources through donations; others argue that organizations serving public purposes in arts, health, or education that rely on fee income still are engaged in public service, and that tax-exempt status ensures a focus on such service rather than on profit. The resolution of this debate could have a profound effect on the structure of the nonprofit sector in the future.

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The Two Nonprofit Sectors: Fee for Service Versus Donative Organizations

By the year 2000, there will be two relatively distinct nonprofit sectors in the United States. The first, which we might call the philanthropic nonprofit sector, will comprise donatively supported organizations such as charities for the relief of the poor and distressed, cultural organizations such as museums and performing-arts groups, and institutions dedicated to research and higher education. The second nonprofit sector will comprise the so-called “commercial” nonprofits (Hansmann, 1980)—that is, nonprofits that receive virtually all of their income from the sale of services rather than from donations and that frequently compete directly with for-profit firms. This second nonprofit sector, which we might call the commercial nonprofit sector, will include, for example, most nonprofit hospitals, health maintenance organizations, medical testing labs, nursing homes, health and life insurance companies, day-care centers, and fitness centers. This commercial nonprofit sector scarcely existed in 1900; by the year 2000, it is likely to account for more than two-thirds of the nonprofit sector as a whole.

Reasons for the Emergence of the Second Nonprofit Sector

In considerable part, the second nonprofit sector has evolved out of the first one. Hospitals provide the most important, con-

spicuous, and well-analyzed example. Until this century, nonprofit hospitals were philanthropic institutions devoted primarily to the care of the poor and were dependent on donations for most of their income. But a series of revolutions in the technology and financing of health care changed that situation radically in recent decades, to the point where now the prosperous as well as the poor use hospitals, and where the overwhelming majority of hospital patients, rich or poor, are able to pay, either directly or through private or public insurance, for the services they receive. Consequently, most nonprofit hospitals today receive virtually no meaningful amount of donative income and have become purely commercial nonprofits (Gray, 1986).

Now that the function of providing subsidized care for the poor has largely been taken away from them, nonprofit hospitals may be considered anachronistic, providing no important services that are not provided as well or better by for-profit hospitals. Nevertheless, even after two decades of strong competition from chains of aggressively expansionist for-profit hospitals, the market share of nonprofit hospitals remains almost exactly what it was twenty-five years ago and shows little sign of declining in the future (American Hospital Association, 1987). This strong resilience of the nonprofit hospitals long after their *raison d'être* has disappeared is probably due to several factors.

First, despite the claims of their detractors (for example, Herzlinger and Krasker, 1987), nonprofit firms evidently often operate with considerable efficiency when faced with financial stringency and hence cannot easily be driven out of business simply through competition from for-profit firms. Second, the capital that is invested in nonprofit firms cannot be withdrawn and invested in other industries without great difficulty; consequently, whether or not that capital is bringing in a market rate of return, it tends to remain locked into the industry. Third, nonprofit hospitals continue to have the advantage of tax exemption and various other public-policy preferences, though the available empirical evidence is ambiguous as to whether these subsidies have had a strong effect on their market share (Hansmann, 1987b). And fourth, administrators and medical staff affiliated with existing nonprofit hospitals probably have a stake in retaining the nonprofit form, which may offer them greater

control, financial remuneration, and protection from competition than would for-profit firms.

Not all commercial nonprofits have evolved from philanthropic ones, however. There are some industries in which commercial nonprofits have played an important role in the industry from its inception. One of the clearest and most interesting instances of this, and one of the oldest as well, is consumer savings banking (Hansmann, forthcoming; Rasmussen, 1988). That industry, which first took shape at the beginning of the nineteenth century, was initially populated almost exclusively by nonprofit firms, in the form of mutual savings banks. (Despite their name, mutual savings banks, unlike mutual savings and loan associations, are not consumer cooperatives but rather are true nonprofits with no elements of depositor ownership.) Here the nonprofit form served a fiduciary role toward the bank's depositors, providing important protection for them at a time when stock banks were too risky for ordinary citizens to trust with their live's savings.

In time, however, state and federal regulation, as well as the increasing maturity of the banking industry itself, endowed stock banks with a degree of trustworthiness comparable to that of nonprofit banks. Indeed, with the adoption of federal deposit insurance in the 1930s, mutual savings banks lost their comparative advantage entirely and became anachronistic. Yet they have continued to occupy a significant place on the economic scene for another half century, probably for reasons similar to those outlined above in the case of hospitals.

There are many other industries heavily populated with commercial nonprofits that seem to have followed one or the other of these patterns of evolution. Indeed, both patterns may be present in many industries. For example, the commercial nonprofits that are found today in the nursing-home industry and the day-care industry seem to have evolved in part from firms that originally were established as philanthropic entities, although it also appears that many of these firms were essentially commercial nonprofits from their founding and presumably adopted the nonprofit form to offer some extra degree of assurance to prospective customers that they would provide quality care.

As I have already suggested, the two industries that I have focused on as examples here, hospital care and savings banking, are industries in which commercial nonprofits appear today to serve no functions that cannot be served as well or better by for-profit firms. And the same conclusion could be drawn about commercial nonprofits in other industries, such as health maintenance organizations, health insurance, and medical testing. Yet we cannot safely conclude that commercial nonprofits are always nonfunctional. There may well be some industries in which commercial nonprofits today serve much the same role that they served in the savings bank industry in its early stages, providing a degree of fiduciary protection for customers against opportunistic behavior in an environment where consumers are for some reason in a poor position to police the quality of service that a firm promises or delivers. For example, although there is much debate on the subject, some commercial nonprofits may be serving such a function today in the nursing care and day-care industries (Hansmann, 1987a).

In any event, the tendency of nonprofit firms to become embedded once they are established indicates that, in the absence of any changes in public policy, we are likely to face a constantly growing population of commercial nonprofits, many of which will be anachronistic. Indeed, given the tendency of government to take over many of the functions traditionally performed by charity, philanthropic nonprofits are likely to find their role continually shrinking as the number of commercial nonprofits expands.

The Response of the Law

Having surveyed some of the reasons for the emergence of the two nonprofit sectors, we can begin to consider how public policy has been responding to this development and how it is likely to respond in the future. Although the pattern is slightly complicated, we can say in general that, if current trends continue, by the year 2000 the two nonprofit sectors are likely to be strongly distinguished in law as well as in fact.

Tax Law. This tendency is most conspicuous in the area of taxation. In principle, the federal corporate income tax presumes

that all nonprofit corporations are taxable unless they can establish that they fit into one or another specific exemption set out in the Internal Revenue Code. In practice, however, the definitions have traditionally been interpreted so broadly as to encompass nearly all nonprofits of any financial significance. And the same has largely been true of state property and sales taxes. In effect, nonprofits as a class have been presumed exempt, and only special types of nonprofits have ever been taxed. In general, the words *nonprofit* and *tax-exempt* have been synonymous.

The emergence of the second nonprofit sector has now begun to threaten this regime seriously. Many of the new commercial nonprofits appear so clearly to be providing services that are no different from those offered by for-profit firms that continued tax exemption is conspicuously difficult to rationalize (Hansmann, 1981a). And, in fact, Congress has recently taken strong action in this regard, withdrawing tax exemption in 1986 from nonprofit organizations "providing commercial-type insurance" (Internal Revenue Code Section 501(m)—which has been interpreted to include, for example, Blue Cross/Blue Shield). There is good reason to believe that this is simply the beginning of an assault on the exemption for many types of commercial nonprofits. At least one member of Congress has already proposed withdrawing tax exemption from nonprofit hospitals (Jaschik, 1987), for example, and it is reasonable to suspect that the exemption for hospitals will soon come under much broader attack. And if nonprofit hospitals lose their exemption, federal corporate tax exemption for most or all of the second nonprofit sector may then be in doubt. The same applies, moreover, to state and local taxes, including not just state corporate income taxes but also property and sales taxes. Indeed, some states have already begun to restrict exemption for hospitals (*Utah County v. Intermountain Health Care, Inc.*, 709 P.2d 265 [Utah 1985]), fitness centers (Davis, 1986), and other types of commercial nonprofits.

As a result of this development, serious thought will have to be given in the years ahead to defining the appropriate scope of tax exemption. Should all commercial nonprofits be denied

exemption, thus in effect extending the exemption only to donative nonprofits? Or should some commercial nonprofits still be exempt? If so, which ones? Should the tax code try to track the distinction, suggested above, between commercial nonprofits that are anachronistic and those that continue to perform a role that distinguishes them from for-profit firms? Would such a distinction be administrable—for example, in the form of a commerciality test of some type? Does it make most sense for the legislature to proceed on an industry-by-industry basis here, as it has in the case of insurance? (see Hansmann, 1981a).

Note, moreover, that many of the new commercial nonprofits continue to obtain their exemption under the general exemption granted “charities.” For example, the nonprofit insurance companies from which Congress recently withdrew exemption had previously been exempted as charities. Thus, the refashioning of tax law to deal with the second nonprofit sector is going to force legal scholars and lawmakers to think more seriously about what is meant by the concept of charity—a task that is about four hundred years overdue.

Wherever the line is ultimately drawn between exempt and nonexempt nonprofits, in the end there is likely to be a large portion of the nonprofit sector that is nonexempt. Indeed, perhaps the great bulk of the sector will be nonexempt. And if this happens, the distinction between exempt and nonexempt organizations will come to be a highly visible line of demarcation between the two nonprofit sectors.

What would happen to the size and scope of the second nonprofit sector if tax exemption were withdrawn from it? It is hard to say. On the one hand, the existing empirical work suggests that the market share of nonprofit firms is relatively more sensitive to tax exemption than is that of for-profit firms (Hansmann, 1987b). On the other hand, experience with nonprofit-seeking firms in other sectors, such as mutual insurance companies, suggests that once such firms are well established, the absence of tax exemption or other perquisites does not inhibit their ability to maintain their share of the market (Hansmann, 1985). It is quite possible that the nonprofit hospitals, nursing homes, day-care centers, health maintenance organi-

zations, home health care agencies, and other institutions that populate the second nonprofit sector will come to appear to us much as mutual insurance companies do now—that is, as essentially commercial entities that do not much differ from their for-profit competitors and that are not treated much differently by public policy.

Other Forms of Special Treatment. Even if, as predicted above, tax exemption is ultimately withdrawn from most or all of the second nonprofit sector, the donatively supported nonprofits that make up the first nonprofit sector seem likely to retain their exemption (and probably the charitable deduction as well). But a different pattern is emerging in other areas of the law where nonprofits have heretofore received special treatment. In a number of these areas, the response to the rise of the second nonprofit sector has been to withdraw preferential treatment not just from the commercial nonprofits that constitute that sector but from *all* nonprofits. Labor law is an example. Prior to 1970, virtually all nonprofit organizations were exempted from federal labor law. But in that year, the National Labor Relations Board (NLRB) began to use its discretion to withdraw this exemption from selected nonprofits (Cornell University, 183 National Labor Relations Board 329 [1970]). A critical step in this process was Congress’s decision in 1973 to pass legislation specifically withdrawing labor-law exemption from nonprofit hospitals (Public Law 93-360, amending Section 2(2) of the National Labor Relations Act)—a decision presumably based on the increasingly commercial character of nonprofit hospitals. Yet the process did not stop there, and by 1976 the NLRB had proceeded to withdraw exemption from *all* nonprofits, including even small charities supported entirely by donations (*St. Aloysius Home*, 224 National Labor Relations Board 1344 [1976]).

Moreover, a similar process seems under way in other areas, from antitrust law (*NCAA v. Board of Regents*, 104 S. Ct. 2942 [1984]) to subsidized postal rates (39 U.S. Code Annotated Section 3626). Thus, the rise of the second nonprofit sector is threatening the privileges of the traditional philanthropies as well.

Corporate Law. Nonprofit corporation law has also been struggling to come to grips with the emergence of two distinct nonprofit sectors. In particular, the American Law Institute has recently released a new Model Nonprofit Corporation Act, which is being proposed for enactment by states throughout the country. In contrast to most existing nonprofit corporation statutes, this act formally splits all nonreligious nonprofits into two different categories. Traditional charities are to be included in the first of these categories, while social clubs and other membership organizations are to be included in the second. Just where most commercial nonprofits are to go in this scheme is presently quite unclear. But there are indications that many of them are intended to be put into the second category, thus creating a further division between the two nonprofit sectors (Hansmann, forthcoming).

Mixed Cases

So far we have been speaking of a growing divergence between two different types of nonprofit organizations. But much the same development is also occurring *within* individual nonprofits. Without giving up their reliance on donative support, many philanthropic organizations in the first nonprofit sector are engaging in increasing amounts of commercial activity to increase their income. It is commonly said that the reason for this is that nonprofits have recently become financially hard pressed as a result of cutbacks in public and private support. There is probably some partial truth to this; nonprofits seem to struggle hard to maintain their established level of activity and seek actively to find new sources of funding to take the place of older sources that are suddenly lost. But it seems mistaken to infer that, in general, nonprofits engage in commercial activity in proportion to the degree to which demand for their charitable and other unremunerative services exceeds the available sources of philanthropic funding. For it would follow from such an explanation that the commercial activity of nonprofits should have been most extensive not now but rather earlier in the century, when the need for the charitable services and public goods provided by nonprofits was far greater and the sources of private

and public support for the nonprofit sector were much smaller than they are today. A better explanation for the long-term trend toward expanding commercial activity on the part of otherwise philanthropic nonprofits is that in part it is a response to the tax and other advantages that have come to be afforded such activities and in part it reflects the increasing sophistication and legitimation of commercial activity by nonprofits in general that have resulted from the rapid expansion of the second (principally commercial) nonprofit sector.

In any event, the same problems that are arising between the two nonprofit sectors are also appearing within individual organizations. Thus, to take one conspicuous example, the taxation of unrelated business income has recently become a very lively topic of debate (United States, 1987).

Implications for Policy

Issues Facing Nonprofit Managers. As a consequence of the emergence of the second nonprofit sector, managers of nonprofit organizations are now faced with large and difficult questions about the purposes their organizations are to serve. Managers of the new commercial nonprofits, in particular, must constantly ask themselves whether, and why, the fact that they are nonprofit affects what their organization is doing—and, most importantly, how it affects what their organization *should* be doing. Should a nonprofit hospital try hard to provide services that are somehow different from those offered by a for-profit hospital? Should the YMCA's fitness centers offer services that are clearly different from those offered by for-profit fitness centers? If so, just *how* should their services be different? If not, why are they nonprofit, much less tax-exempt, and should they consider altering their form from a nonprofit corporation to a business corporation? In short, organizations within the second nonprofit sector are faced with a massive identity crisis, and the managers of these institutions are somehow going to have to deal with it. Moreover, even a minor identity crisis of this sort affects the managers of traditional philanthropies every time they decide whether to undertake a new commercial venture.

Issues Facing the Organized Nonprofit Sector. The emergence of two distinct nonprofit sectors creates a dilemma for national and local organizations that seek to represent the interests of the nonprofit sector as a whole. For, as we approach the year 2000, the interests of the two nonprofit sectors may increasingly diverge. For example, rather than fighting to retain special subsidies and preferences, such as tax exemption, for *all* nonprofits, it may be in the interest of the first nonprofit sector—the philanthropic nonprofits—to protect itself by, as it were, throwing the second nonprofit sector to the wolves. More particularly, the traditional philanthropies may wish to lobby for the establishment of a clear line between those nonprofits that will continue to benefit from special preferences, such as tax exemption, and those that will not and to place the commercial nonprofit sector on the far side of the line. The alternative could be that preferences will ultimately be lost for *all* nonprofits, including the philanthropic ones. In short, when it comes to preferential treatment for nonprofits, it may be rational for the philanthropic nonprofit sector to conclude that, if united we stand, then united we will fall.

A divergence of interests between the two nonprofit sectors may also emerge in corporation law, though here it is likely to take a slightly different form. For example, while it will be in the interest of many commercial nonprofits to be governed by the relatively permissive mutual benefit provisions of the new Model Nonprofit Corporation Act, it may be in the interest of the philanthropic nonprofits to have the commercial nonprofits, like the philanthropic nonprofits, governed by the more stringent public benefit provisions, thus reducing the likelihood of opportunism and fraud on the part of commercial nonprofits that might tarnish the public image and detract from the public support of the nonprofit sector as a whole.

Issues Facing Lawmakers. The evolution of the two nonprofit sectors also continues to face lawmakers with serious issues of public policy. I have argued elsewhere (for example, Hansmann, forthcoming) that there are strong reasons for the organizational law of nonprofits (in particular, nonprofit corporation law) to abandon the newly emerging tendency toward establishing dif-

ferent categories of nonprofits with different standards and to impose instead a uniform set of relatively strict fiduciary constraints on all nonprofits, regardless of whether they are in the first or the second nonprofit sector. Similarly, it makes sense for regulatory law (such as securities law and antitrust law) to abandon the remaining distinctions among different types of nonprofits and to treat them all similarly, whether they are in the first or the second nonprofit sector—and moreover to treat them essentially the same as for-profit firms. In contrast, tax law should continue its present trend toward ever greater discrimination between the first and second nonprofit sectors, reserving privileged treatment only for the former, which will be an increasingly smaller subset of all nonprofits. Whether these or other views will prevail, however, remains uncertain.

Conclusion

The very forces that have caused the nonprofit sector to grow so rapidly in recent decades have also led to important shifts in the composition of that sector. Those changes are likely to continue between now and the year 2000, leaving us with an even more diverse—and divided—set of organizations than we have now. As a consequence, there will be difficult questions of policy to be addressed in the years to come, both for lawmakers and for leaders within the nonprofit sector itself.

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The Complexities of Income Generation for Nonprofits

Nonprofit organizations rarely survive on donations alone. In fact, few nonprofits even receive a substantial portion of their revenues from donations. Among a random sample of 274 tax-deductible organizations that I surveyed for the tax years 1973-1975 (Weisbrod, 1988), some 38 percent of tax-deductible nonprofits received 10 percent or less of their revenues from donations; half received less than 25 percent from donations. Nonprofits are typically involved in a variety of fund-raising markets to make up the balance of revenues. Often they encounter the proprietary sector of the economy as they pursue other sources of revenue. Small businesses particularly resent nonprofits' for-profit endeavors. Responding to numerous complaints from the small-business community, Frank Swain, the Small Business Administration (SBA) chief counsel for advocacy, said, "Small private businesses are laboring under a tax code which taxes them but not some of their competitors—nonprofit organizations doing business for profit" (Swain, 1983). The SBA and various industry groups within the small-business community increasingly refer to nonprofits as "unfair competition."

This criticism of nonprofits combines both factual and normative issues. In this policy debate, the following questions need

Note: This chapter draws heavily from Chapter 6 of my book *The Nonprofit Economy* (Cambridge, Mass.: Harvard University Press, 1988).