THE

Nonprofit

ECONOMY

BURTON A. WEISBROD

The Nonprofit Economy

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The Nonprofit Economy

To my father and my late mother,
Leon and Idelle Weisbrod,
who helped me to appreciate the
importance of ideas and scholarship

and to my wife, Shirley,
for her understanding and moral
support during the preparation
of this book, and for her
help in improving its readability

Preface

Modern economies are complex systems that operate through a variety of institutional forms. There is no perfect institution that works well for all societies in all circumstances. Each society must find the particular combination of institutional forms that suits its needs at a given time. Every society confronts the problem of deciding how to encourage and restrict providers so that they furnish the goods and services that society needs. Gathering and assessing information are problems that plague all modern societies and make such evaluations difficult.

My view is that nonprofit organizations are largely a way of solving informational problems. Managers of nonprofit organizations lack the incentive of profit that might otherwise tempt them to misrepresent their products or services. Some people think, for example, that nonprofit blood banks, hospitals, or nursing homes are safer than those run for profit. A different point of view is that the profit motive encourages efficiency and user satisfaction. Still a third point of view is that the government, rather than either nonprofit or for-profit institutions, is the best resource society has for meeting its economic goals.

For various reasons (such as cultural and religious diversity and the traditional American emphasis on private initiative), nonprofit organizations play an integral role in the United States economy. We encourage nonprofits by exempting them from certain kinds of taxes and subsidizing them in various ways. In exchange, we require that nonprofit institutions refrain from distributing any profits to managers or directors. Since World War II the nonprofit sector of our economy has doubled (from 2 percent to 4 percent of national income), but that growth has not been accompanied by the economic analysis required for appropriate policy formulation. There are now nearly one million tax-exempt nonprofit organizations in the United States. The time has come for a thorough analysis of their functioning within the economy and their effects on other economic sectors.

We need to find out how the nonprofit economy works and to evaluate its success in meeting the goals our society has set for it. Is its privileged economic position justified by the effect it has on our overall economy? Or, on the other hand, does the nonprofit sector have unexpected negative effects on other parts of the economy?

We can ask the same kinds of questions and use the same kinds of economic models to analyze the nonprofit sector as those that are used to study the rest of the economy. It is commonplace that the private sector and the government intersect within our economy and that the actions of one influence the other. Nonprofits—a hybrid form of institution combining aspects of the for-profit and governmental forms—also have an effect on, and are affected by, the rest of the economy.

The Nonprofit Economy is my attempt to apply economic analysis to this neglected sector of the economy. I begin by placing the nonprofits in the context of a mixed economy of governmental, for-profit, and nonprofit institutions; I also discuss the variety of forms that nonprofits themselves may take. In Chapter 2 I introduce the concept of "institutional choice"—that society chooses among these institutional forms to meet the demands of the society. In Chapter 3 I extend the institutional choice perspective by considering the problems of rewarding performance in the various economic sectors.

The rest of *The Nonprofit Economy* analyzes the workings of the nonprofit sector per se. In Chapter 4 I introduce a "collectiveness index" to highlight the important relationship between the ways an organization is financed and the kinds of services it provides. I also describe the nonprofit sector—its overall size, composition, and changes over time. In Chapters 5, 6, and 7 I discuss the financing of nonprofit organizations in detail. I examine the effect of charitable donations both on nonprofits themselves and on governmental and for-profit institutions, as well as the factors affecting the level of donations. Then I take up a growing source of revenue for nonprofits, which is also a source of growing resentment toward them—sales of goods and services. The third major source of financing nonprofits—volunteer labor—is the subject of Chapter 7; volunteer labor may account for as much as 20–25 percent of the labor performed in the service sector.

In Chapter 8 I ask whether nonprofits behave differently from for-profit institutions. As a society, we support nonprofits in the belief that they provide outputs that cannot be provided profitably by private enterprise. But do nonprofits act differently in providing outputs that are hard for consumers to monitor or in the manner in which those outputs are distributed?

Finally, in Chapter 9 I present some public-policy recommendations. It is clear that more research must be done on the subject of the nonprofit economy and its effect on the economy as a whole. In the meantime, it is important that we think hard about our attitude toward the nonprofit sector. I hope that my suggestions will stimulate further research and an ongoing debate over the role of nonprofit organizations in the American economy.

To this end, I have addressed this book to a wide audience, for even readers with little background in economics will be able to follow the arguments I make in the text. I also think *The Nonprofit Economy* will be of interest to more specialized readers—economists and other social scientists. Notes and statistical appendixes are provided for those who wish to refer to them.

I received financial support for this research from the Twentieth Century Fund, which I acknowledge with thanks. A number of people helped me in major ways, and I wish to thank them also. I benefited from research assistance from Thomas Helminiak and Jerald Schiff, and from editorial assistance from Jocelyn Riley and Elizabeth Uhr. Christoph Badelt read the entire manuscript and provided detailed comments and valuable insights on both substance and style.

The Nonprofit Economy

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ONE

Nonprofits in a Mixed Economy

The economy of the United States is mixed. It includes private enterprise, sizable governmental activity, and a commonly overlooked middle ground, the nonprofit sector.

Nonprofit organizations are all around us. We donate money to them. We volunteer our labor to them. We give government grants, tax advantages, and postal subsidies to them. Many of us send our young children to nonprofit day-care centers, our older children to nonprofit colleges, our sick to nonprofit hospitals. We go to nonprofit museums and zoos. *National Geographic* Magazine, "Up With People," and the Sierra Club are all nonprofit entities. So are the Better Business Bureaus nonprofit, as are the Boy Scouts, the YWCA, labor unions, trade associations, and, quite likely, the local country club. The nonprofit sector of the economy is large and heterogeneous, and it is growing.

The term *nonprofit* has several meanings. The one I emphasize is the restriction on what an organization may do with any surplus ("profit") it generates. The essence of this form of institution is that a nonprofit organization may not lawfully pay its profit to owners or, indeed, to anyone associated with the organization. Along with this restriction, however, come a variety of tax and subsidy benefits that influence a nonprofit's actions.[1]

There are also hybrid combinations of nonprofits with private firms on the one hand and with governmental organizations on the other. These are neither entirely private nor entirely public, but have some attributes of each. The post–World War II period has been one of active experimentation with nonprofit and related hybrid forms of organizations. The federal government has sought "newer mechanisms whereby programs of national concern can be conducted essentially outside of the federal establishment itself." Such use of private nonprofit organizations by the federal government began with the Rand Corporation.[2] Another example is the Urban Institute, in Washington, D.C., a private nonprofit research organization established by the federal government in the 1960s under the Johnson administration. At least in the early years, the Urban Institute, while technically independent, was funded primarily by the Department of Housing and Urban Development and worked largely on projects the department approved.

A more recent institutional form is a hybrid combination of a nonprofit and a for-profit. One of the largest for-profit hospital chains in the nation, Hospital Corporation of America, has formed a nonprofit foundation, the HCA Foundation, which gives grants to other nonprofit organizations.[3] In another recent institutional innovation, a nonprofit, the Enterprise Foundation, established the for-profit Enterprise Development Company, which has been described as "a tough-minded, business-like real estate development company that specializes in downtown [retail and festival] projects. It is run to make a profit, it pays its taxes. But it[s] . . . profits are plowed into programs and projects to aid in eliminating the problems of housing the poor within a generation."[4]

Yet another form of hybrid is the "joint venture" of nonprofits with for-profit firms. In 1985 a hospital was organized by the for-profit firm, National Medical Enterprises, and the nonprofit Methodist Health Systems. In fact, a survey of 700 nonprofit hospitals by the accounting firm Ernst and Whinney showed that in 1985 one-third of the nonprofits were already involved in joint ventures with for-profits and most of the others were considering it.[5]

No simple public policy will suffice for such a mixed collection. It is not clear, either, what society expects from the nonprofit sector. Many opinions and assertions are put forth about the effectiveness and desirability of nonprofits, but evidence is scarce. Especially limited is information about whether nonprofits are better or worse at achieving certain goals than for-profit firms or governmental enterprises would be.

It is difficult to formulate good public policy without knowing what nonprofits actually do, how well they do it, and how they respond to various incentives and constraints. Several variables are involved. To the Internal Revenue Service, nonprofits are a major headache, producing only trivial tax revenues but sizable administrative—and even constitutional—problems, such as whether a university that discriminates against blacks should retain its nonprofit status. To the courts, nonprofits are an endless source of litigation over such matters as how they may solicit donations and what part of their revenues, if any, should be subject to taxation; in 1985 alone, nonprofit activities were the subject of six cases before the United States Supreme Court and sixteen before the United States Court of Appeals.[6] To private enterprises, nonprofits are sources of subsidized, "unfair" competition. To the population in general, nonprofits are sometimes a nuisance, continually pleading for donations; at the same time they are outlets for the expression of social concerns. The nonprofits regard themselves, however, as socially valuable organizations, vital contributors to a pluralistic society. Are they worth the trouble?

Misperceptions about nonprofits abound. One is that they exist outside the economic mainstream. Their millions of volunteer workers are not counted in Department of Labor statistics. Their billions of dollars of contribution to the nation's economic output have not, until recently, been reported separately by the Department of Commerce. Information about what nonprofits do is uncoordinated and difficult to find. Little is reported on any regular basis as to the size or activities of the nonprofit portion of the economy. Even the term *nonprofit* itself is used inconsistently. A 1982 Census Bureau survey of the service sector illustrates the unfortunate state of statistical information and the low level of importance that is attached to the nonprofit sector. After the survey was designed, a decision was made (because of cost constraints) to omit major groups of nonprofits—such as schools and hospitals—with the result that there is little comparability between this survey and the 1977 survey.

It is also widely believed that all nonprofits are essentially the same, that all are guided by public-spirited altruists who seek only to serve the public interest or, conversely, by shrewd entrepreneurs who have found in nonprofits a mechanism for lining their own pockets. Nonprofits, however, are a varied lot.

Another common misperception is that nonprofits exist almost entirely on the donations of the citizenry. This is simply wrong. The variability of the sources of support among nonprofit organizations is enormous, as is the importance of nondonated revenues. A related misperception is the tendency to think of nonprofits as somehow not subject to the economic constraints that apply to the rest of the economy. The authors of a recent article in the *Harvard Business Review*, for example, asserted that a nonprofit hospital is "an institution free of market discipline."[7] The absence of stockholders does matter, but nonprofits—hospitals or others—are by no means free of market pressures. Some people believe that nonprofits do not respond to changes in prices or in demand, that consumers of services from nonprofit organizations do not respond to the prices of their services, and even that prospective donors are not influenced in deciding the size of contributions by the prospect of tax deductibility. These ideas, too, are wrong. Not only does charitable giving of money respond to the same kinds of factors that influence markets for "ordinary" commodities—prices, incomes, seller reputation, and so forth—but so does giving of time (volunteer labor). Although monetary revenues are certainly of enormous importance to the vitality of nonprofits, so, too, is the vast amount of nonmonetary contributions of volunteer labor services. As policymakers consider alternative mechanisms for enhancing (or, perhaps, limiting) the resources flowing into the nonprofit sector, they need to recognize that a wide array of governmental decisions influence that flow, even when the decisions seemingly pertain only to other parts of the economy.

The origins of organizations that are neither government nor private profit oriented are obscure. Whatever the motivations may have been for their development, they have been around for centuries. At first their existence had nothing to do with tax considerations, for the history of private nonprofit organizations long antedates the existence of taxes on personal income and on corporate profits. In the United States, the deduction for charitable giving was added to the federal income tax law in 1917, four years after the adoption of the Sixteenth Amendment, which permitted taxation of personal income. In 1918 an estate tax deduction was added for charitable bequests, but it was 1935 before corporations were first allowed to make tax-deductible contributions.[8] These tax deductions presumably had only a small effect on giving prior to World War II, for income tax rates were tiny until then. Now, with far higher rates of personal and corporate taxation, tax rates are a major influence on charitable giving.

In certain respects the nonprofit form of enterprise antedates governmental service agencies. Four centuries ago, in sixteenth-century England, governmental provision of civilian goods or services was modest. Yet voluntary private "philanthropies" (today we would call them nonprofits) were providing funds for a wide range of goods and activities that are now regarded as the natural responsibility of government: schools, hospitals, toll-free roads, fire-fighting apparatus, public parks, bridges, dikes and causeways, drainage canals, waterworks, wharves and docks, harbor cleaning, libraries, care of prisoners in jails, and charity to the poor.[9] Nonprofit organizations supported even such causes as "houses for young women convinced of their folly."[10] More recently, in nineteenth-century America, we find such nonprofits as the Anti–Horse Thief Society, formed in 1884 apparently to "supplement" inadequate governmental efforts.[11]

Choice of Institutional Forms

Every society makes choices about what forms of institutions it will rely on to achieve its socioeconomic goals.[12] The search for more efficient forms of institutions, including the invention of new hybrids, is not limited to the United States. The year 1985 saw the socialist economy of Hungary introduce "new management forms" that combine state ownership with elements of private cooperatives. The reforms call for less state control and more self-governance by the workers in state enterprises, the goal being stronger managerial incentives. The new institutional forms remain subject to central governmental price setting, but they have "autonomous, comprehensive budget and banking relations."[13]

Although the purely private enterprise and the government institution have many virtues, they also have serious limitations. For example, private enterprise, driven by profit seeking, cannot be relied on to undertake activities, such as pollution control and consumer health and safety protection, that would be unprofitable even if consumers valued them highly. And government enterprises face political pressures that make them excessively responsive to well-organized demands from industry and other pressure groups but far less responsive to the interests of poorly organized groups such as consumers.

In the United States, the limitations of both government and private enterprise are drawing attention to nonprofits. Although they, too, have drawbacks, nonprofits have unique features that might enable them to serve important social aims that neither the private sector nor the government can fulfill very well. The unique nature of the nonprofit economy and its relations (both competitive and complementary) with the private sector and the government are the subject of this book. I focus on four major themes: informational inequalities, diverse demands, the relationship between revenue sources and outputs, and the interdependency of the for-profit, nonprofit, and governmental sectors of the economy.

The efficiency of any institutional form depends to a large extent on *informational inequalities* in the market where it functions. Informational asymmetry can involve either underinformed consumers or informed consumers who choose to understate their true demands for collective-type services. When consumers are well informed relative to suppliers, the private sector is usually the institution of choice. But when consumers are underinformed relative to suppliers, the private sector often performs badly. In such areas as long-term medical care, day care, charity, and foreign aid, consumers are often in a poor position to determine the quality of output and thus may be ill served by opportunistic sellers.

Informational asymmetry in the reverse direction is the source of the "free-rider" problem. Consumers, in the aggregate, may highly value particular collective services, such as national defense, clean air and water, and aid to the poor and needy. But individual consumers may find that self-interest dictates acting as if they cared little, in the hope that others will pay for the services. Consumers do not have the incentive to reveal their true willingness to pay, by making voluntary payments, if they feel that they can benefit from others' contributions.

Both kinds of informational inequalities permit opportunistic behavior, which causes market "failure"—private markets that do not work efficiently. The nonprofit and governmental forms may be able to mitigate such behavior by virtue of their constraints on the distribution of profits. Indeed, the nonprofit sector includes organizations that provide services subject to both types of informational problems. Some provide services traditionally identified with the private sector that can be sold to individuals but with a consumer-protection or informational element added; nursing home services are an example. Other nonprofits provide collective-type services that are traditionally identified with the public sector—for example, basic scientific research. There are also nonprofits, such as country clubs and trade associations, in which informational inequalities play no part.

The second theme of this book, that consumers have *diverse demands,* also has important consequences for nonprofits. In a democratic society in which governments tend to be responsive to majority wants, there is a need for institutions that can respond to the demands of persons who feel intensely about particular collective-type activities, such as the preservation of Carnegie Hall or other landmarks, research on muscular dystrophy, or helping native Americans.

The third theme is that there is a close relation between an organization's *sources of revenue and the nature of its outputs.* This is true for all organizations, whether governmental, for-profit, or nonprofit. An organization that relies heavily on income from sales, for example, cannot engage in activities promoting environmental preservation that, however valuable socially, cannot be sold profitably. An organization that relies on donations to aid the poor must tailor the form of that aid to the wants of prospective donors, who are, in effect, the economic demanders of the organization's services.

Finally, the fourth theme is that *the nonprofit sector of the economy is interdependent with the governmental and for-profit sectors.* Both the outputs it provides and the revenue sources it uses bring it into competitive as well as complementary relations with the other forms of institutions. When government reduces personal income tax rates, for example—perhaps to stimulate economic growth or, as was the case in 1986, to simplify the tax system—contributions to nonprofits decline. And when nonprofits respond by extending their activities in search of additional revenues, they come into increased competition with the private sector.

Public Policy

Public policy toward nonprofits—to the extent there is one—can be described most aptly as confused. Government simultaneously encourages and discourages nonprofits—subsidizing them and restricting them, proclaiming their virtues and distrusting them. This is not surprising, since there is little consensus as to what goals society should achieve by fostering nonprofits. And without a consensus there cannot be tests of whether goals are being reached or even approached.

I believe that there should be a policy debate to help shape thinking about the role of nonprofits in our mixed—and changing—economy. The first step in such a debate is to clarify the issues. Although there are many questions, they can be classified in two categories. What kinds of activities should nonprofits engage in? How should nonprofits be financed?

To identify the appropriate range for nonprofit activities, we must recognize both the strengths and limitations of the nonprofit form of institution as well as of other forms. There is little point in encouraging nonprofits to compete with proprietary firms in activities for which the