1. A law and economics perspective on nonprofit organizations

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1. INTRODUCTION

The field of law and economics concerns using economic analysis to design better laws and legal and regulatory institutions. Classic applications of this field examine social efficiency and distributional consequences, the theory of the firm, assignment of property rights, minimizing transactions costs, delegation and agency problems and tort law. Nonprofit organizations present variations on these classic law and economics themes, as well as many other elements of the literature, and papers applying the tools of law and economics to nonprofit issues are appearing more regularly. But, to our knowledge, no one has attempted to draw together this scattered literature. That is our main task for this chapter. In the process of bringing this literature together, we note differences between the law and economic analysis of for-profit and non-profit institutions and highlight the opportunities to develop new literature that focuses on these differences.

A. Defining Nonprofit Organizations

We use Henry Hansmann's definition: a nonprofit organization is one prohibited by law or irrevocable internal decisions from distributing profits to those in control of the organization.[1] This 'nondistribution constraint' is found in every US state's nonprofit corporation statute, and has been found useful as one of several defining characteristics used to gather data for the 45-country Johns Hopkins Comparative Nonprofit Sector Project.[2] This differs from other definitions that stress purpose (eg, not established to make money) by focusing on a structural characteristic that has consequences for economic behavior. Other organizational structures with social purposes, like co-operatives and worker-managed firms, do not qualify, as they distribute profits. However, mutual savings banks do qualify, despite distributing profits to members, as the board of directors does not receive distributions and members have no control rights. Nondistribution of profits prohibits distributions in the form of entrepreneurial and (arguably) managerial compensation, a corollary to the nondistribution constraint that Hansmann calls the 'fair compensation constraint'.

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1 Henry B Hansmann, 'The Role of Nonprofit Enterprise' (1980) 89 *Yale Law Journal* 835.

2 Lester Salamon and Helmut K Anheier, 'In Search of the Nonprofit Sector: The Question of Definitions' (1992) 3 *Voluntas* 125.

Anne Preston also looked at nonprofit corporation statutes and proposed an additional requirement present in most US states, the 'public benefit constraint'.[3] She modeled this as a requirement that nonprofits spend at least a minimum prescribed amount on collective (also known as public) goods, but her idea did not catch on. We regard the public benefit constraint as a way to regulate, rather than a defining characteristic of, nonprofit organizations. Gabriel Kaplan took an entirely different approach.[4] Noting problems with the enforcement of nondistribution, he characterized nonprofits as organizations in which rights to distribution are unclear and perpetually contested. This insight may prove useful in future law and economics perspectives, but has not yet been incorporated in economic models.

The nondistribution constraint is not consistently, or well, defined in practice. First, what counts as a distribution of profit? Accounting profit (revenues minus explicit costs) or economic profit (revenues minus all opportunity costs)? Is a distribution based on revenue enhancement alone, or cost reduction alone, a distribution of profit? Second, who are the controlling parties? Only board members, or also top management? Third, how can nondistribution be enforced if the organization merges, converts to a for-profit or some other profit-distributing corporate form, or declares bankruptcy? Finally, how can we enforce nondistribution? Is distribution in hard-to monetize forms (board meetings at fancy resorts, penthouse offices at prime locations, on-the-job leisure) restricted, and how can that be accomplished? Jurisdictions around the world vary in how they respond to these questions.

B. Consequences of Nondistribution

The nondistribution constraint has three immediate behavioral consequences.[5] First, nonprofits cannot obtain traditional equity financing. Nonprofit organizations can issue shares, but because shareholders cannot receive any dividends or capital gains, shareholder payments are a form of donation. But share issuance is not necessary to receive donations, which Wedig regarded as an investment that produces dividends in kind.[6] The absence of traditional equity capital alters the firm's capital structure, with consequences (discussed below) for the size, growth, entry and exit of nonprofit firms.

Second, nonprofits are not hindered by the market for control. Without traditional equity capital, there can be no financially motivated takeover bids from shareholders who force the organization to pursue profits.[7] This means that nonprofit organizations

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[3] Anne Preston, 'The Non-Profit Firm: A Potential Solution to Inherent Market Failures' (1988) 26 *Economic Inquiry* 493.

[4] Gabriel E Kaplan, 'The Nondistribution Constraint: Fact or Fiction in Higher Education?' (1999) paper presented at the 28th annual ARNOVA conference, Alexandria, Va.

[5] Richard Steinberg and Marc Bilodeau, 'Donative Nonprofit Organizations' in SC Kolm and J Mercier-Ythier (eds), *Handbook on the Economics of Giving, Reciprocity, and Altruism*, Vol 2 (Elsevier 2006) 1271.

[6] Gerald Wedig, 'Risk, Leverage, Donations and Dividends-In-Kind: A Theory of Nonprofit Financial Behavior' (1994) 3 *International Review of Economics and Finance* 257.

[7] Unfriendly takeovers have occurred, but these are motivated by member conflict over how to pursue the organization's mission and are restricted to nonprofits with member-elected

that pursue other goals can persist in that pursuit. Deviations from profit maximization can be socially beneficial (charity care, liberal arts education, advocacy), wasteful (creating secure jobs that produce nothing of value) or abhorrent (promoting hatred of marginalized groups).[8] Freedom from the control of the market does not end all consideration of profits, for even a nonprofit must break even to survive. Sometimes nonprofits maximize profits from some activities to cross-subsidize other activities, but such profits are a means to an end within the organization and not an end in themselves.[9]

Finally, nondistribution of profits may make nonprofit organizations more trustworthy than for-profit firms in the most difficult cases of asymmetric information, when contract compliance is not verifiable by third parties and so cannot be enforced. Hansmann called this 'contract failure' and argued that when, either due to the trading environment or the nature of the good itself, consumers are unable to verify the quantity or quality of the good they seek, for-profits have both the incentive and ability to short change the customer. Nonprofits, he argued, are more trustworthy in such cases, because the owners cannot profit from cheating donors, clients or customers. His argument is controversial, and we shall discuss it further below.

C. Is the Law and Economics of Nonprofit Organizations Different from Law and Economics Generally?

What distinguishes law and economics analyses of nonprofit organizations from analyses of other rules and institutions? This question has not received explicit discussion in the literature, but we believe some distinctions are worth pursuing in the future. First, we consider the criteria for judging laws, rules, and institutions. Next, we consider the relationship between ownership and efficiency. Last, we consider the theory of the firm.

1. Application of social welfare theory

The field of law and economics judges arrangements using the tools of social welfare theory, social efficiency and social welfare functions. Efficiency is a subtle concept, but is based entirely on the preferences of each individual in the economy: an economy is socially efficient if the only feasible way to make one person better off (by their personal judgments) requires that at least one other person be made worse off. Social welfare is a function that incorporates efficiency and the social planner's judgment regarding distributional justice. We wish to emphasize that a *single vision* of distributional justice belongs in a social welfare function.

Nonprofit organizations are mission driven, and we can think of missions as multiplicities of alternative social welfare functions. This adds another layer of

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boards. Dana Brakman Reiser, 'Nonprofit Takeovers: Regulating the Market for Mission' (2006) *Brigham Young University Law Review* 1181.

[8] Richard Steinberg, 'Nonprofits and the Market' in Walter W Powell (ed), *The Nonprofit Sector: A Research Handbook* (Yale University Press 1987).

[9] Estelle James, 'How Nonprofits Grow: A Model' (1983) 2 *Journal of Policy Analysis and Management* 350.

judgment – the multiplicities of individual preferences and organizational preferences – to the single vision of a social-welfare function. How, if at all, should the organizational-level multiplicity integrate into the single vision? Are organizations simply producers of goods, whose value is fully accounted for by individual-level utility, or should organizational mission-attainment count somehow independently? This departure from traditional analysis is worth thinking about in the nonprofit context.

Nonprofits contribute to expressions of the rights of free speech and association, fundamental in developed democracies, and in the USA to the concept of limited government.[10] These rights are valued in and of themselves and not just because free speech is beneficial. Consider two equally effective nonprofit advocacy groups with opposing missions. In traditional welfare analysis, each group creates external costs for the members of the opposing group. Because the two groups are equally effective, public policy does not change, so the activities of both nonprofits would seem to be a pure waste. But somehow, our judgment needs to account for the fact that, as outlets for expressing alternative views of the public good, the contest produces value and legitimates acceptance of the single view implemented by government.

Thus, the collective expression of diverse notions of the public good by nonprofit organizations has value, and ought to be protected from an opposing consensus view. Expression of the voluntary impulse, the right of any gang of idiots to form an association to make the world a better place, also has value.[11] Beyond rights, pluralistic provision has beneficial consequences. A vibrant ecology of contesting ideas allows experimentation and policy innovation, tests the truth of ideas others take for granted, and encourages the development of community connection and morality. Thus, US Supreme Court Justice Powell wrote of the ‘important role played by tax exemptions in encouraging diverse, indeed often sharply conflicting, activities and viewpoints’. He went on to argue that ‘the provision of tax exemptions to nonprofit groups is one indispensable means of limiting the influence of governmental orthodoxy on important areas of community life’.[12]

However, tough questions arise when extreme alternative notions of the public good are legitimized. Clearly, nonprofit organizations deserve no general exemption for criminal acts, but perhaps they should be partially forgiven if these acts are expressive. Should nonprofit organizations that sponsor illegal but nonviolent protests have their charter and/or tax-exempt status revoked? Other conflicts between majoritarian and minority expressions of the public good arise in cases of discrimination.

Another expressive mission of some nonprofit organizations is to alter individual preferences. Drug and alcohol treatment facilities do not just want to make abuse more difficult for their clients, they want their clients to prefer a clean life over the life they had been living. Social marketing campaigns conducted by some nonprofits seek to make people want to practice safe sex, want to eat the right foods, want to put their cell phones away. Religious congregations often want to make believers of infidels.

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[10] Matthew Harding, *Charity Law and the Liberal State* (Cambridge University Press 2014).

[11] Richard Steinberg ‘The Clash of Values in the Civil Society’ (1995), unpublished paper on file with one of the authors.

[12] *Bob Jones University v United States* (1983) 461 US 574, 609.

Traditional social welfare analysis takes preferences of individuals as given, and so is unsuited to judging the value of these kinds of organizations to the economy.

Many nonprofit missions are explicitly paternalistic, intending to overrule individual preferences. If they cannot change individual preferences, drug and alcohol treatment facilities seek to do just this. There are good reasons why traditional social welfare analysis relies on self-assessed well-being,[13] but some nonprofit missions encompass cases where the value of consumer sovereignty is less clear – as in the treatment of severe mental illness, or the protection of children from their own follies.

Finally, many nonprofit missions are concerned with aspects of the distribution of wellbeing: filling holes in the social safety net, empowering marginalized people, equalizing opportunities, making key goods affordable, or supporting favoured elites. This raises two questions.[14] First, how should social welfare functions reflect the conflicting visions of distributional justice embodied in nonprofit missions, if at all? Second, how should social welfare functions reflect distributional issues other than the distribution of income, such as the wellbeing of individuals with disabilities? Do we take varying views on these matters as simply evidence that we are not sure what weighting scheme we should use in our social welfare functions, or count diverse views as building blocks of the model and develop some way of aggregating them for social judgments? What do we make of organizations that help individuals (say, undocumented aliens) contrary to the political consensus?

2. Attenuated ownership and efficiency

Some argue that the lack of residual claimants makes nonprofits essentially unowned organizations, but it seems better to characterize nonprofits as having a different or attenuated ownership structure. One of the three components of full ownership, the right to direct the use of assets, resides in the board, whereas the right to retain any financial surpluses and the right to sell the first two rights to a new owner are absent.[15] Papers continue to appear that oversimplify the implications of attenuated ownership, arguing that the absence of residual claimants reduces monitoring intensity, leading to shirking and other forms of productive inefficiency. More nuanced analyses are found in the early law and economics literature,[16] and new twists on the subtleties of relative efficiency predictions continue to appear.[17] These analyses need further development,

[13] On whether traditional social welfare analysis can be reconciled with many forms of paternalistic regulation, see Richard H Thaler and Cass R Sunstein, *Nudge: Improving Decisions About Health, Wealth, and Happiness* (Penguin 2009); Brian Galle, 'The Problem of Intrapersonal Cost' (in press) *Yale Journal of Health Law, Policy, and Ethics*.

[14] Charles T Clotfelter, *Who Benefits from the Nonprofit Sector?* (University of Chicago Press 1992).

[15] Avner Ben-Ner and Derek Jones, 'Employee Participation, Ownership, and Productivity: A Theoretical Framework' (1995) 34 *Industrial Relations* 532.

[16] Kenneth W Clarkson, 'Some Implications of Property Rights in Hospital Management' (1972) 15 *Journal of Law & Economics* 363; Hansmann (n 1); Eugene F Fama and Michael C Jensen, 'Agency Problems and Residual Claims' (1983) 26 *Journal of Law and Economics* 327.

[17] Al Slivinski, 'Team Incentives and Organizational Form' (2002) 4 *Journal of Public Economic Theory* 185; Edward L Glaeser and Andrei Shleifer, 'Not-for-profit Entrepreneurs' (2001) 81 *Journal of Public Economics* 99.

particularly if we want to extend results to new hybrid organizational forms that combine elements of nonprofit and for-profit organizations.[18]

3. Theory of the firm

Standard theories of the firm as a legal and practical institution may also differ in the nonprofit setting. Ronald Coase defined the firm as the boundary separating market transactions (outside) from nonmarket transactions (inside).[19] Firms exist because of transaction costs that make nonmarket internal allocation processes more efficient than market processes for some activities. The theory has been used to analyse the efficiency of various firm structures, mergers, conversions, conglomeratizations and spinoffs and the like.

While clear conceptions of 'inside' and 'outside' the nonprofit firm remain undeveloped, many commentators have applied the general transaction-cost framework to nonprofits.[20] In that theory, organizations attempt to minimize 'agency costs', or losses due to opportunistic behaviour by individual participants in collaborative endeavours.[21] Contracting to prevent opportunism is costly.[22] Rules governing nonprofit firms can be analysed through this more limited lens, in which the question is not overall efficiency or social welfare, but the parties' optimal balancing of agency and contracting costs. For example, Krashinsky observes that the nondistribution constraint may represent a low-cost mechanism for contracting between entrepreneur and customer.[23]

2. THE ROLES OF THE FOR-PROFIT, NONPROFIT, AND GOVERNMENT SECTORS

The collective body of literature known as three-failures theory considers for-profit firms, nonprofit firms, and government agencies and analyses the comparative advantages of each sector. The bulk of received three-failures theory is from economics, but political science and several other disciplines are represented in elements of the theory. The theory includes both positive (which activities are likely to occur in each sector) and normative (which activities ought to be assigned to each sector) elements. Here we

[18] Brian Galle, 'Self-Regulation of Social Enterprise' in Benjamin Means and Joseph Yockey (eds) *Cambridge Handbook of Social Enterprise Law* (Cambridge University Press 2018).

[19] Ronald Coase, 'The Nature of the Firm' (1937) 4 *Economica* 386.

[20] Oliver E Williamson, 'Transaction-Cost Economics: The Governance of Contractual Relations' (1979) 22 *Journal of Law and Economics* 233.

[21] Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305.

[22] Ibid.

[23] Michael Krashinsky, 'Transaction Costs and a Theory of the Nonprofit Organization' in Susan Rose-Ackerman (ed), *The Economics of Nonprofit Institutions* (Oxford University Press 1986).

briefly review the theory.[24] Then we review the rationales for government support of nonprofits and the forms such support can take, concluding with an overview of government regulation of nonprofits.

A. Three-Failures Theory

Students in an introductory economics class learn about perfect competition and the invisible hand theorem, then about market failure and governmental solutions to this problem. Three-failures theory takes the analysis two steps further, noting that governments have their own failures, and nonprofits help to address both government and market failures. Finally, nonprofits have their own shortcomings (voluntary failure) that governments and markets respond to. Collectively, the three failures lead to activities that either will, or should, reside in each sector and activities that will, or should, occur in multiple sectors, or through cross-sectoral partnerships. From the three-failures theory, we distil some of the advantages and disadvantages of placing activities in each sector below.

1. For-profit firms

For-profit firms have an advantage providing private goods without externalities. At least in theory, when all goods are traded in perfectly competitive markets, equilibrium is socially efficient. In practice, some goods are not tradeable (non-excludable collective goods, externalities when Coase solutions are costly or impractical, and unowned goods), firms have market power, firms suffer from internal agency problems, and rapid convergence to the socially efficient outcome is far from assured. More importantly, the invisible hand theorem says nothing about social objectives like distributional justice. For-profit price discrimination may favour the poor, but only to the extent that doing so enhances profits and will not lead to purchases by those whose willingness to pay is less than the marginal cost of production.[25]

The two most important market failures for three-failures theory are the under-provision of nonexcludable collective goods and contract failure in difficult cases of asymmetric information.[26] A collective good is something that is consumed simultaneously by a group of individuals. Once the good is provided, it costs society nothing to let an additional person consume it. Some collective goods are excludable, meaning it is possible to restrict enjoyment to paying customers (for example, an academic lecture or an operatic production). Others are nonexcludable, such as national defence or broadcast public radio. Nonexcludable collective goods cannot be sold because the

[24] See Richard Steinberg, 'Economic Theories of Nonprofit Organizations' in Walter W Powell and Richard Steinberg (eds), *The Nonprofit Sector: A Research Handbook*, Second Edition (Yale University Press 2006) 117, for a more complete review.

[25] Richard Steinberg and Burton A Weisbrod, 'Pricing and Rationing by Nonprofit Organizations with Distributional Objectives' in Burton A Weisbrod (ed), *To Profit or Not to Profit: The Commercial Transformation of the Nonprofit Sector* (Cambridge University Press 1998) 65.

[26] We neglect a third relevant market failure due to space limitations – over exclusion when excludable collective goods are provided. See Steinberg (n 24).

nonpaying customer enjoys the good for free. Any price that for-profits charged would in effect be a suggested donation.

While donations could be used to finance nonexcludable collective goods, contract failure severely limits the amount of donations made to for-profit firms. Here, the problem is that donors can observe *whether* the good they donated to is produced and perhaps how much was spent to produce it, but cannot observe whether their donation caused the amount of spending on the good to *increase*. This is called marginal impact contract failure. For-profits have the incentive and ability to divert marginal donations fully towards marginal profits. Understanding this, for-profits do not seek, and donors do not offer, donations.

For-profits do contribute to collective good provision in the forms of corporate donations, sponsorships, and corporate social responsibility expenditures. For-profit social enterprises also contribute. These contributions are often made as part of a strategy for increasing profits, and there is no reason to expect that the profit-maximizing level of contributions to collective goods would correspond with socially optimal expenditures. When these contributions are not strategic, they result from agency problems between managers and owners, and the market for control limits managerial discretion to depart from maximizing distributions to owners. See the survey by Steinberg for details, additional discussion of socially conscious investing, and a discussion of the special factors that permit the for-profit Newman's Own to donate 100 per cent of profits to charity.[27]

Marc Bilodeau and Al Slivinski model another agency problem that for-profit entrepreneurs would have financing a collective good.[28] Modelling the nonprofit/for-profit entrepreneurial choice as a three-stage game, a founding entrepreneur makes an initial investment or donation, then seeks additional capital from others in the second stage. In the third stage, the founding entrepreneur responds to the second stage investments. If she has chosen the for-profit form, she can add or subtract from her initial investment; if nonprofit she can add to but not subtract from the initial investment (because withdrawing the initial investment would violate the nondistribution constraint). Second-stage investors would not invest in a for-profit, because they recognize that the entrepreneur would respond by withdrawing some of her initial investment in the third stage. The nondistribution constraint makes the initial entrepreneurial investment irreversible, and second-stage investors contribute more with that assurance.

2. Governments

Governments are often defined by their monopoly on legitimate coercive power, which gives them an advantage in revenue collection. The mandatory nature of taxes overcomes free-riding problems, and the monopoly position of government fosters economies of scale in revenue collection. However, mandated taxes are distortionary, and the resulting dead-weight loss counts against the advantages of government

[27] Richard Steinberg, 'What Should Social Finance Invest In and With Whom?' in Alex Nicholls, Rob Paton, and Jed Emerson (eds), *Social Finance* (Oxford University Press 2015) 64.

[28] Marc Bilodeau and Al Slivinski, 'Rational Nonprofit Entrepreneurship' (1998) 7 *Journal of Economics and Management Strategy* 551.

finance. The power to tax and budget resources for social problems is constrained by the electorate (or other political factors when democracy is imperfect or absent), and this is the focus of formal political-economic models of government spending.

Burton Weisbrod began the three-failures theory with his analysis of the financing of collective goods.[29] After noting that for-profits will not finance excludable collective goods, he looked at the political-economic equilibrium between government and nonprofits. He modelled political equilibrium using the median voter theorem (political equilibrium is the ideal point of the median-preference voter in a representative or direct democracy), but all that matters for his theory is that some voters will want government to spend on each collective good. High demanders want government to spend more, which James calls 'excess demand'.[30] When voters have 'differentiated demand', they prefer differing versions of the collective good (eg, traditional, religious, Montessori or military-based primary schools) and this also leads to dissatisfaction with the political equilibrium. When voter preferences are homogeneous, excess and differentiated demand is insufficient to overcome the transactions costs and loss of economies of scale from alternatives to government finance. As heterogeneity grows, excess- and differentiated-demand voters supplement government finance by buying from and donating to nonprofit organizations. In turn, voters recognize private financing and vote for lower tax-financed expenditures.[31]

In sum, Weisbrod's theory predicts that increases in voter heterogeneity result in higher donations (and perhaps purchases from nonprofits) and lower government spending. These predictions are borne out in the few empirical studies available.[32] Weisbrod's theory is about public vs private finance of collective goods, not public vs private provision. Voters who support elevated levels of government expenditure may also support government contracting out with for-profit and/or nonprofit providers.[33] Modifications and extensions of Weisbrod's theory apply it to multi-level governments, interest group politics, and relations between nonprofits and the state.[34]

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[29] Burton Weisbrod, 'Toward a Theory of the Voluntary Nonprofit Sector in a Three-Sector Economy' in Edmund S Phelps (ed), *Altruism, Morality, and Economic Theory* (Russell Sage Foundation 1975).

[30] Estelle James, 'Why Do Different Countries Choose a Different Public-Private Mix of Educational Services?' (1993) 28 *Journal of Human Resources* 571.

[31] Richard Steinberg, 'Voluntary Donations and Public Expenditures in a Federalist System' (1987) 77 *American Economic Review* 24.

[32] James (n 30); Yoshiho Matsunaga, Naoto Yamauchi and Naoko Okuyama, 'What Determines the Size of the Nonprofit Sector?: A Cross-country Analysis of the Government Failure Theory' (2010) 21 *Voluntas: International Journal of Voluntary and Nonprofit Organizations* 180.

[33] James M Ferris and Elizabeth Graddy, 'Organizational Choices for Public Service Supply' (1994) 10 *Journal of Law, Economics, & Organization* 126; see also Richard C Feiock and Hee Soun Jang, 'Nonprofits as Local Government Service Contractors' (2009) 69 *Public Administration Review* 668; Eva M Witesman and Sergio Fernandez, 'Government Contracts with Private Organizations: Are There Differences Between Nonprofits and For-profits?' (2013) 42 *Nonprofit and Voluntary Sector Quarterly* 689.

[34] Julian Wolpert, 'Social Income and the Voluntary Sector' (1977) 39 *Papers, Regional Science Association* 217; James (n 30); Steinberg (n 31); Brian Galle, 'The Role of Charity in a Federalist System' (2011–2012) 53 *William and Mary Law Review* 777.

Government failure has been defined many ways, but we will use the term to talk about government's failure to obtain social efficiency. Weisbrod's theory illustrates one of the main sources of government failure – government decision-makers are answerable to an electorate or political power structure that does not insist on social efficiency. Government spending on collective goods, in the median voter model, is socially efficient only if preferences for spending levels are symmetrically distributed. And when account is taken of political forces in more complete models of political equilibrium, even this may not be enough. Another reason for government failure is that absent competitive threats to government's monopoly power, productive inefficiency occurs. Contracting out with competitive bidding reduces that inefficiency, but when contract failure is involved, competitive bidding can make the problem worse.[35]

Broadening the definition of government failure to consider values other than social efficiency, government decisions on distributional issues are determined more by political forces than philosophies of distributional justice. James Douglas points to constraints on government action required for legitimacy.[36] He argues that in order for the social contract to be seen as legitimate, governments must follow a 'categorical constraint'. Government must be seen to practice equality before the law, whereas private action can more easily tailor to coreligionists, coethnics, and individual circumstances. He concludes: 'At its best, voluntary action can be based on true charity; ultimately, state action has to be based on justice.'[37] He then applies this and other government constraints to issues of diversity, experimentation and bureaucracy.

3. Nonprofit organizations

Nonprofits are able to pursue missions other than profit maximization, and to do so without threat of takeover. Nonprofits provide collective goods, partly filling gaps left by the other sectors.[38] Nonprofits do not need to build a majoritarian consensus before acting, and hence can act more nimbly to address unexpected social problems. Nonprofits are supported largely by voluntary action, not coercive taxation, although in some industries government is the primary funder of nonprofits.

Nonprofits may be more trustworthy in cases of contract failure for four reasons. First, owners cannot profit from delivering less than the promised quantity or quality because of the nondistribution constraint. Second, entrepreneurs interested in nonfinancial objectives may be more likely to choose the nonprofit sector.[39] Third, employees may become socialized into a corporate culture that supports trustworthiness. Finally, board members are often consumers (perhaps on behalf of others they care about) of the services rendered by nonprofits.[40] However, the trust advantage is

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[35] Richard Steinberg, 'Competition in Contracted Markets' in Perri 6 and Jeremy Kendall (eds) *The Contract Culture in Public Services* (Ashgate 1997) 161.

[36] James Douglas, 'Political Theories of Nonprofit Organization' in Walter W Powell (ed), *The Nonprofit Sector: A Research Handbook* (Yale University Press 1987) 46.

[37] Ibid.

[38] Weisbrod (n 29).

[39] Hansmann (n 1).

[40] Avner Ben-Ner, 'Nonprofit Organizations: Why Do They Exist in Market Economies?' in Susan Rose-Ackerman (ed) *The Economics of Nonprofit Institutions: Studies in Structure and Policy* (Oxford University Press 1986) 94.

controversial because of the potential presence of 'for-profits-in-disguise' – organizations that incorporate as nonprofits and benefit from donations and tax exemption, but secretly find a way to distribute profits to owners. In addition, the absence of one motive to short-change clients and donors does not eliminate other motives, such as the desire to support an unpopular mission. Finally, in industries where nonprofits compete with for-profits, most consumers are confused or uninterested in the sector of the organization they choose,[41] and some consumers perceive that for-profits are more trustworthy.[42]

Further, the nonprofit advantage in trustworthiness is expected to be largest when there is a single nonprofit provider. When nonprofits compete, for-profits may be forced to become more trustworthy, because consumers who find it hard to tell whether a given organization is trustworthy are more likely to choose nonprofit providers; faced with a harder-to-fool clientele, for-profits find it in their interest to deliver the promised quality and quantity of services.[43] In contrast, when nonprofits compete with for-profits-in-disguise, they may need to become less trustworthy to survive. Empirical evidence on the subject is mixed, at least in part due to methodological challenges.[44] However, research that looks at more observable and less observable attributes of quality supports a nonprofit advantage in the latter.[45]

Many sources of voluntary failure limit the role of nonprofits. Lester Salamon detailed four of them: philanthropic amateurism, particularism, paternalism and insufficiency. The last is simply another name for the free-rider problem, discussed elsewhere, but there has been surprisingly little quantitative empirical work on the other three, and on whether each of these shortcomings may be strengths in particular contexts.[46] Another purported voluntary failure is the three i's of inefficiency, indolence, and inattention, although this too is controversial, with mixed empirical evidence.[47] Finally, there is controversy over the differences in the availability of financial capital for nonprofits, a subject we shall detail below.

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[41] Femida Handy et al, 'The Discerning Consumer: Is Nonprofit Status a Factor?' (2010) 39 *Nonprofit and Voluntary Sector Quarterly* 866.

[42] Elizabeth Mauser, 'The Importance of Organizational Form: Parent Perceptions versus Reality in the Day Care Industry' in Walter W Powell and Elisabeth S Clemens (eds) *Private Action and the Public Good* (Yale University Press 1998) 124.

[43] Richard A Hirth, 'Consumer Information and Competition Between Nonprofit and For-Profit Nursing Homes' (1999) 18 *Journal of Health Economics* 18.

[44] Mark Schlesinger and Bradford H Gray, 'Nonprofit Organizations and Health Care: Some Paradoxes of Persistent Scrutiny' in Walter W Powell and Richard Steinberg (eds), *The Nonprofit Sector: A Research Handbook*, Second edition (Yale University Press 2006) 378.

[45] Avner Ben-Ner, Pinar Karaca-Mandic and Ting Ren, 'Ownership and Quality in Markets with Asymmetric Information: Evidence from Nursing Homes' (2012) 12 *The B E Journal of Economic Analysis & Policy* (Online), DOI: <https://doi.org/10.1515/1935-1682.3038>.

[46] Steinberg (n 11).

[47] Steinberg (n 24) describes the controversy. For discussion of the evidence, see Schlesinger and Gray (n 44).

B. Government Support

Dennis Young and John Casey offer three views of the relationship between government and nonprofit organizations: supplementary (as in Weisbrod's theory), complementary (through contracting out and less-hierarchical partnerships), and adversarial (as in watchdogs or advocates for change).[48] Government supports nonprofits in line with the first two views, often conditioning that support on limits to the adversarial role of nonprofits.

1. Forms of support

Governments around the world provide different forms of support to nonprofit organizations.[49] We focus on support in the USA in this chapter, which illustrates the range, but not the details, of forms of support.

Support is provided through the tax system, as nonprofit organizations are exempt from entity taxes, such as the federal corporate income tax and most state and local income, sales, and property taxes. It is difficult to quantify the benefit of tax exemption, but Evelyn Brody and Joseph Cordes estimate the exemption from the federal corporate income tax provides about $10 billion, and exemption from state and local property taxes between $8 and $13 billion per year.[50] There are limits, as income from activities considered unrelated to the organization's 'exempt purpose' are taxed by the federal unrelated business income tax; private foundations must pay an excise tax; and organizations sometimes offer PILOTs (payments in lieu of taxes) and SILOTs (services in lieu of taxes) under agreements with state and local tax authorities. Another subsidy is provided through (limited) authority to issue tax-exempt bonds, which provides about $4.3 billion per year to nonprofits,[51] and there are a variety of indirect tax subsidies (such as education, dependent care, and low-income housing tax credits). Simon, Dale, and Chisolm provide the details, nuances, and caveats to this brief summary.[52]

On the donor side, charitable contribution deductions from the federal personal and corporate income taxes, and from the estate tax, encourage gifts to organizations that

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[48] Dennis R Young and John Casey, 'Supplementary, Complementary, or Adversarial? Non-Profit-Government Relations' in Elizabeth T Boris and C Eugene Steuerle (eds) *Nonprofits and Government: Collaboration and Conflict*, Third Edition (Rowman and Littlefield 2017) 37.

[49] Pamala Wiepking and Femida Handy, 'The influence of government support for the nonprofit sector on philanthropy across nations' in Pamala Wiepking and Femida Handy (eds) *The Palgrave Handbook of Global Philanthropy* (Palgrave Macmillan 2015) 530; Allison Dunn, Oonagh B Breen and Mark Sidel, 'Regulatory Waves: A Conclusion' in Marion Fremont Smith (ed), *Regulatory Waves: Comparative Perspectives on State Regulation and Self-Regulation Policies in the Nonprofit Sector* (Cambridge University Press 2016) 221.

[50] Evelyn Brody and Joseph Cordes, 'Tax Treatment of Nonprofit Organizations: A Two-Edged Sword?' in Elizabeth T Boris and C Eugene Steuerle (eds) *Nonprofits and Government: Collaboration and Conflict* (Urban Institute Press 2006) 141.

[51] Brody and Cordes (n 50).

[52] John Simon, Harvey Dale and Laura Chisolm, 'The Federal Tax Treatment of Charitable Organizations' in Walter W Powell and Richard Steinberg (eds) *The Nonprofit Sector: A Research Handbook*, Second Edition (Yale University Press 2006) 267.

meet legal requirements.[53] Oversimplifying, nonprofits lose the right to receive deductible donations when they engage in certain restricted activities, such as campaigns for political office. Donations are often deductible from state and local personal income taxes, and some states offer additional support through tax credits and deductions for donations to specified kinds of nonprofit organizations. These deductions and credits reduce the effective price of giving – the amount of after tax income that must be sacrificed in order to provide the charity with an additional dollar. Note that the net level of support provided through the charitable tax deduction is probably less than the gross support, as one of us finds that a one per cent decrease in the after-tax price of giving is correlated with a two per cent increase in fundraising expenditures.[54]

Government also supports nonprofits through grants and contracts. About seven per cent of US federal grant assistance went directly to nonprofit organizations in the 2012 fiscal year, amounting to $27.2 billion.[55] Some federal grants to state and local governments flowed through to nonprofits, and an additional $9.2 billion went to (mostly nonprofit) private higher education. Researchers found that 4.2 per cent of federal government contracts were with nonprofits, about $20 billion total. Again, grants and contracts are costly to secure and manage, so the net resources provided are somewhat lower than these numbers suggest.[56]

Revenue interactions complicate calculation of the level of support provided by government. Donors may react positively to the seal of approval provided when an organization receives a government grant,[57] or donors may feel that an organization receiving support from the government does not need their donations, and react negatively.[58] Government money influences charitable outputs, as organizations compromise their mission to become eligible for more support in some cases. In other cases, untied government support may free the organization from mission compromises needed to bring in donations. These factors can cause a positive donor response or a negative one.[59] Thus, the amount of expected crowding-out or crowding-in of donations is specific to the organization, type of funding, strings, matching requirements, and donor perceptions. Arjen de Wit and his co-authors synthesize the large body of empirical literature on these points.[60]

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[53] For some in-kind gifts, particularly those of publicly traded stock, donors escape taxation on built-in gains and can also deduct the full value of the asset contributed.

[54] Brian Galle, 'How Do Nonprofit Firms Respond to Tax Policy?' (2017) 45 *Public Finance Review* 364.

[55] Jesse Lecy and Jeremy Thornton, 'What Big Data Can Tell Us About Government Awards to the Nonprofit Sector: Using the FAADS' (2016) 45 *Nonprofit and Voluntary Sector Quarterly* 1052.

[56] Kirsten Grønbjerg, *Understanding Nonprofit Funding* (Jossey-Bass 1993).

[57] Susan Rose-Ackerman, 'Do Government Grants to Charity Reduce Private Donations?' in Michelle White (ed), *Nonprofit Firms in a Three-Sector Economy* (Urban Institute Press 1981).

[58] Steinberg (n 31).

[59] Susan Rose-Ackerman, 'Ideals versus Dollars: Donors, Charity Managers, and Government Grants' (1987) 95 *Journal of Political Economy* 810; Rose-Ackerman (n 57).

[60] Arjen de Wit and Renee Bekkers, 'Government Support and Charitable Donations: A Meta-analysis of the Crowding-out Hypothesis' (2016) 27 *Journal of Public Administration*

2. Rationales for support

There are two main categories of rationales for tax exemption and deductibility – tax-base refinements and subsidy theories. The first set of arguments is purely legal and normative – what should be included as personal or corporate income for purposes of an income tax, as part of an estate in an inheritance tax, as property in a property tax, and as purchases and sales in a sales tax? Thus Boris Bittker and George Rahdert support nonprofit exemption from the corporate income tax because the tax focuses on income from activities pursued for personal gain and, in any case, it would be difficult to properly calculate tax liability; Hansmann disagrees with the latter argument.[61] William Andrews and Bittker each use the Haig-Simons definition of the income tax base (income is consumption expenditure plus the change in net worth) and argue that donated income is neither element,[62] although Simons himself, his intellectual heir Joseph Dodge, and others, reach the opposite conclusion.[63] John Simon makes a similar argument for the estate tax deduction, although together with Harvey Dale and Laura Chisolm, later observes that no such claim can be constructed to justify the double subsidy (exemption from taxation on the gain in asset value as well as the charitable contribution deduction) given to gifts of appreciated assets.[64]

Subsidy theories argue that nonprofits deserve added support because of the good they do. The most relevant strands of subsidy theories for the field of law and economics are those related to social efficiency. Donations often support a non-excludable collective good and are underprovided in simple models (such as the voluntary contributions mechanism) due to external benefits and free-riding behavior.[65] Deductibility can be seen as a crude corrective for this problem, akin to matching or Pigouvian subsidies. More generally, deductibility can be seen as a second-best solution to optimal government finance of collective goods. This idea has a long history, starting with the intuitive notion of 'treasury efficiency'. A tax break is treasury efficient if it stimulates a greater expenditure on collective goods than the foregone tax revenue. In other words, treasury efficiency is about 'bang for the buck' – whether it is

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Research and Theory 301; Arjen De Wit, Renee Bekkers and Marjolein Broese van Groenou, 'Heterogeneity in Crowding-out: When Are Charitable Donations Responsive to Government Support?' (2017) 33 *European Sociological Review* 59.

[61] Boris I Bittker and George K Rahdert, 'The Exemption of Nonprofit Organizations from Federal Income Taxation' (1976) 85 *Yale Law Journal* 299; Henry B Hansmann, 'The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation' (1981) 91 *Yale Law Journal* 54.

[62] William D Andrews, 'Personal Deductions in an Ideal Income Tax' (1972) 86 *Harvard Law Review* 309; Boris I Bittker, 'Charitable Contributions: Tax Deductions or Matching Grants?' (1972) 28 *Tax Law Review* 37.

[63] Henry C Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (University of Chicago Press 1938) 125; Joseph M Dodge, 'Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income' (1978) 91 *Harvard Law Review* 1177.

[64] John Simon, 'The Tax Treatment of Nonprofit Organizations: A Review of Federal and State Policies' in Walter W Powell (ed), *The Nonprofit Sector: A Research Handbook* (Yale University Press 1987) 67; Simon, Dale and Chisolm (n 52).

[65] Richard Cornes and Todd Sandler, 'The Simple Analytics of Pure Public Good Provision' (1985) 52 *Economica* 103; Louis Kaplow, 'A Note on Subsidizing Gifts' (1995) 58 *Journal of Public Economics* 469.

better for government to tax people to pay for collective goods or to provide an incentive to donate. It is easy to show that the charitable contribution deduction is treasury efficient if the demand for giving is price elastic, that is, if donations increase by more than one per cent when the after-tax price of giving falls by one per cent.[66]

Treasury efficiency is familiar, but too simple. Russell Roberts provided a fuller social welfare analysis.[67] Because income taxes are distortionary, the optimal way to support a collective good minimizes the marginal tax rate while balancing the budget. Government direct finance has two harmful effects – it creates excess burdens from taxation, and it discourages donations through crowding-out. The critical value of price elasticity, dividing the range of price elasticities between cases where direct finance is better and cases where tax breaks are better, depends on both price elasticity and marginal crowdout, and is less than one if government spending reduces giving. In the extreme case of 100 per cent crowdout, direct government funding is useless, incurring excess burdens without increasing expenditures on the collective good. Later authors provide further refinements of the idea of treasury efficiency.[68]

Exemption from entity taxes is generally distortionary, and it is hard to make an efficiency case for such exemption.[69] One of us tried, arguing that the corporate income tax is so distortionary that exempting some organizations reduces excess burdens, and this might outweigh the excess burdens created by differential taxation of commercial enterprises.[70] Tax exemption is at best a second-best solution. Dale issues a four-part challenge to proponents of entity tax exemption.[71] First, he asks how much of the tax break is wasted due to nonprofit inefficiencies. Second, he notes that subsidizing charitable inputs (purchases, property, and use of capital) is not the most effective way to increase charitable outputs (see section 5A of this Chapter). It would be better to eliminate deductions, credits, and exemptions and replace them with tax incentives for charitable outputs (as in the tax breaks offered for historic building restoration or for research activities). Third, output incentives could induce for-profits to provide nonexcludable collective goods, so there is no reason to restrict this kind of subsidy to nonprofits. A similar argument is made by Anup Malani and Eric Posner, albeit with

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[66] Charles T Clotfelter, *Federal Tax Policy and Charitable Giving* (University of Chicago Press 1985).

[67] Russell Roberts, 'Financing Public Goods' (1987) 95 *Journal of Political Economy* 420.

[68] Emmanuel Saez, 'The Optimal Treatment of Tax Expenditures' (2004) 88 *Journal of Public Economics* 2657; Peter Diamond, 'Optimal Tax Treatment of Private Contributions for Public Goods With and Without Warm-glow Preferences' (2006) 90 *Journal of Public Economics* 897; Tomer Blumkin and Efraim Sadka, 'A Case for Taxing Charitable Donations' (2007) 91 *Journal of Public Economics* 1555; Galle (n 54).

[69] Charles Clotfelter, 'Tax-induced Distortions in the Voluntary Sector' (1988–89) 39 *Case Western Reserve Law Review* 663; Henry Hansmann, 'Unfair Competition and the Unrelated Business Income Tax' (1989) 75 *Virginia Law Review* 605.

[70] Richard Steinberg, '"Unfair" Competition by Nonprofits and Tax Policy' (1991) 44 *National Tax Journal* 351.

[71] Harvey Dale, 'Rationales for Tax Exemption', in Independent Sector and United Way Institute, *Looking Forward to the Year 2000: Public Policy and Philanthropy – 1988 Spring Research Forum Working Papers*, 1988.

some later challenges.[72] Finally, Dale argues for a kind of treasury efficiency test to determine whether an entity-tax break is more socially efficient than direct government finance (in the forms of government production of collective goods, grants and contracts to nonprofits, and vouchers or food-stamps for consumers).

State and local tax exemption presents some added complications. In Cambridge Massachusetts, 43 per cent of the land area is tax exempt, due to the presence of Harvard University, MIT, and others. Absent PILOTs, this means that the residents of this city bear all the costs of subsidizing organizations that provide worldwide benefits. This is why PILOTs have been implemented (City Council, City of Cambridge, 2012), but other cities face less cooperative tax-exempt organizations.[73] Steinberg and Marc Bilodeau survey this and other arguments for and against sales and property tax exemptions.[74]

3. SELECTED REGULATORY ISSUES

A. Regulation of Fundraising and Administrative Costs

Donors and regulators are concerned about wasteful spending by nonprofits, particularly in light of attenuated property rights, and focus attention on excessive fundraising and administrative costs. Lacking adequate data to properly detect wasteful spending, donors and regulators instead focus on simple ratios, such as donations received, divided by fundraising and administrative costs, its reciprocal, or its complement, expenditures on charitable program, divided by total expenditures. All make the same mistakes, confusing efficiency and popularity, ignoring life-cycle donation effects, and mismeasuring both charitable revenues and expenditures. This is why the Supreme Court of the USA ruled that ratio-based prohibitions or point-of-solicitation disclosures do not meet the burden required to interfere with charities' core free-speech protections.[75] Ratio measures

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[72] Anup Malani and Eric A Posner, 'The Case for For-Profit Charities' (2007) 93 *Virginia Law Review* 93; Brian Galle, 'Keep Charity Charitable' (2009) 88 *Texas Law Review* 1213; James R Hines Jr, Jill R Horwitz and Austin Nichols, 'The Attack on Nonprofit Status: A Charitable Assessment' (2010) 108 *Michigan Law Review* 1179.

[73] City Council, City of Cambridge MA (2012) Policy Order Resolution, 18 June <http://www2.cambridgema.gov/cityClerk/policyOrder.cfm?item_id=39609> accessed 21 January 2018.

[74] Richard Steinberg and Marc Bilodeau, *Should Nonprofit Organizations Pay Sales and Property Taxes* (National Council of Nonprofit Associations, 1999).

[75] Noting that fundraising speech is inextricably intertwined with core free speech values of advocacy and public education, the Court required that regulations must be narrowly tailored to a compelling state purpose. In three cases, the Court ruled that state laws were constitutionally overbroad, stating: '[T]he use of a percentage-based test was not narrowly tailored to achieve [the] goal [of prevention of fraud]. In fact, we found that if the statute actually prevented fraud in some cases it would be "little more than fortuitous."': *Riley v National Federation of the Blind of North Carolina Inc* (1988) 108 S Ct 2667, 2673 (quoting *Secretary of State of Maryland v Joseph H Munson Co* (1984) 467 US 947); *Schaumburg v Citizens for a Better Environment* (1980) 444 US 620.

confuse averages with marginal effects.[76] Unless contracts specifically require that fundraiser compensation is a percentage of funds raised, the price of giving (the amount a donor must give to increase spending on a charitable program by $1) does not depend in any way on fundraising and administrative cost ratios. Other countries, which are not constrained by constitutional rulings, do regulate cost ratios. These regulations do not prevent fraud or inefficiency; instead, the regulations reduce efficiency.[77]

Good administration is costly, and the required cost varies greatly across organizations, depending on the complexity of programs, scarcity of relevant talents, and burdens imposed on fundees by funders such as special reports and audits. Blunt regulation based on cost ratios would not catch waste by organizations that have low administrative requirements, and blunt regulation of other organizations is harmful. The organization may devote a greater share of its budget to charitable programs, but that money will be wasted if the programs are poorly administered. Pressure to cut administrative cost ratios could also reduce accountability to relevant stakeholders. To our knowledge, the literature is sparse on better regulatory approaches.

B. Regulation of Compensation

The nondistribution constraint implies some limits on the pay of firm insiders. Distribution of profits to individuals in control of the firm raises the same concerns about opportunism as distributions of a share of surplus to investors.[78] It does not necessarily follow that government must regulate managerial pay. In regimes that lack subsidies for charitable activity, enforcement of the nondistribution constraint could be left to private arrangements, although as a practical matter government involvement is likely to be necessary in order to resolve the credibility problems of private monitors (see Galle in this volume for a more complete discussion). Regulation may be especially important when there are negative externalities, such as when large compensation at one institution might put upward pressure on others, or undermine the force of the nondistribution constraint for other firms in the industry.

Generous compensation not formally based on net profits may also implicate the nondistribution constraint or other regulatory concerns. As we discuss below, creditors – including salaried employees – can have interests adverse to other nonprofit stakeholders. If managers are free to pay themselves a salary that is a large fraction of free cash flows, their incentive to create such cash flows raises opportunism worries similar to those presented by formal equity distributions.

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[76] Richard Steinberg, 'The Revealed Objective Function of Nonprofit Firms' (1986) 17 *Rand Journal of Economics* 508.

[77] Richard Steinberg and Debra Morris, 'Ratio Discrimination in Charity Fundraising: The Inappropriate Use of Cost Ratios Has Harmful Side-effects' (2010) 1 *Voluntary Sector Review* 77.

[78] Equity pay for some employees may often be consistent with the nondistribution constraint, assuming that a higher-level manager (herself subject to the nondistribution constraint) is responsible for setting the pay structure and reviewing the performance of the equity-compensated workers. For example, investment managers at US universities are commonly paid a portion of investment returns.

While these theories are relatively straightforward, they are difficult to put into practice. Defining ‘excessive’ compensation, for example, either requires the government to write a pay scale for nonprofit managerial employment – including appropriate incentive pay – or to establish a relevant comparison group for evaluating a given set of managers. Either approach would oblige the regulator to make a series of difficult policy judgments, such as whether the compensation of executives at competitor for-profit firms should be relevant to whether a nonprofit executive’s pay is ‘excessive’.[79]

Regulating excess compensation is likely to have important effects, not only on pay itself, but also on the composition and behaviour of the nonprofit workforce. Some of these effects may be salutary. For example, if material compensation is limited, firms are more likely to employ individuals who are motivated by altruism, ‘warm glow’ or ideological compatibility with the mission of the organization.[80] Empirically, executives of religious hospitals[81] and religiously affiliated institutions of higher education have lower total compensation than executives in secular nonprofits, which is consistent with the theory that ideological alignment can substitute for pay.[82] Pay limits could conceivably help to align managers with the interests of other stakeholders. When contract failure is an issue, the problem is more complicated. Unless unobservable managerial productivity is positively correlated with managerial aversion to opportunism, salary limits create a trade-off between productivity and trustworthiness.[83]

On the other hand, it is likely that the firm’s private optimum would likely have already accounted for non-compensatory worker motivations, so that government limits distort the firm’s choice of contract design. If workers value the nonprofit’s output, the optimal contract will typically provide a mix of cash and nonmonetary rewards,[84] although in the presence of diminishing returns employees will likely prefer that the marginal dollar be salary. Tax considerations also typically favour warm glow and the

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[79] See Brian Galle and David Walker, ‘Nonprofit Executive Pay as an Agency Problem: Evidence from US Colleges & Universities’ (2014) 94 *Boston University Law Review* 1881, for evidence that the US regime for identifying comparison firms increased the growth rate of executive compensation. Undeterred by these obstacles, the US Congress recently enacted a provision imposing an excise tax on selected colleges and universities paying in excess of 1 million US dollars to any employee.

[80] Marc Jegers, *Managerial Economics of Non-Profit Organizations* (Routledge 2008); Susan Rose-Ackerman, ‘Altruism, Nonprofits, and Economic Theory’ (1996) 34 *Journal of Economic Literature* 701.

[81] Jeffrey P Ballou and Burton Weisbrod, ‘Managerial Rewards and the Behavior of For-profit, Governmental, and Nonprofit Organizations: Evidence From the Hospital Industry’ (2003) 87 *Journal of Public Economics* 1895.

[82] Sharon M Oster, ‘Executive Compensation in the Nonprofit Sector’ (1998) 8 *Nonprofit Management and Leadership* 207; Galle and Walker (n 79).

[83] Steinberg (n 35).

[84] Al Slivinski, ‘Team Incentives and Organizational Form’ (2002) 4 *Journal of Public Economic Theory* 185.

like over formal compensation at the margin,[85] and so, on this view, regulation potentially compounds an existing tax distortion.[86]

In addition to its effects on altruistic or warm glow motivations, lower pay might attract managers who prefer shirking, desire autonomy to pursue their own projects without regard to stakeholder preferences, or who are generally of lower ability.[87] In addition, firms might compensate managers with job security,[88] even if ideally the firm (or the central planner) would have preferred managers to be more risk seeking. Changes along these margins are harder to justify as corrective.

If regulation is motivated mostly by the failure of the pay-setting process to reflect the preferences of stakeholders, an alternative to direct regulation of compensation would be to reduce the transaction costs for stakeholders to assert control directly.[89] Ballou and Weisbrod[90] suggest that firms use complex pay structures to reduce outside scrutiny (and Bebchuck and Fried[91] tell a similar story in the public company context), and Galle and Walker[92] report evidence that quasi-random shocks to the transparency of relative pay at US colleges and universities affects donor support. Transparency thus has some potential promise as a regulatory tool. While disclosure is no panacea to be sure,[93] increasing transparency of compensation structures may allow market mechanisms to do more work in restraining executive pay, taking some pressure off law. Better disclosure might also reduce firms' incentives to engage in inefficient but opaque pay structures, such as the common practice at US universities of delivering substantial compensatory value via free housing.[94]

Here again there is a possible tension, however, between donor-centred and social-planner-driven visions of the nonprofit sector. Donors may have visceral reactions to 'excessive' compensation or overhead, even when paying for quality staff would

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85 Galle and Walker (n 79).

86 On the other hand, the tax 'distortion' can be efficient to the extent that it encourages what might be termed 'public-benefit perks', or non-cash rewards that align management with the social planner's preferences.

87 Linda Sugin, 'Resisting the Corporatization of Nonprofit Governance: Transforming Obedience into Fidelity' (2007) 76 *Fordham Law Review* 893.

88 Anup Malani and Albert H Choi, 'Are Non-Profit Firms Simply For-Profits in Disguise? Evidence from Executive Compensation in the Nursing Home Industry' (Social Science Research Network 2004) SSRN Scholarly Paper ID 617362 <https://papers.ssrn.com/abstract=617362> accessed 27 January 2018.

89 See Avner Ben-Ner and Theresa Van Hoomissen, 'The Governance of Nonprofit Organizations: Law and Public Policy' (1994) 4 *Nonprofit Management and Leadership* 393, for discussion of legal alternatives for controlling agency problems.

90 Ballou and Weisbrod (n 81).

91 Lucian A Bebchuk and Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press 2004).

92 Brian Galle and David Walker, 'Donor Reactions to Salient Disclosures of Nonprofit Executive Pay: A Regression Discontinuity Approach' (2016) 45 *Nonprofit and Voluntary Sector Quarterly* 787.

93 For a general critique of disclosure as regulation technique, see Omri Ben-Shahar and Carl Schneider, *More Than You Wanted to Know: The Failure of Mandated Disclosure* (Princeton University Press 2016).

94 Galle and Walker (n 92)

markedly improve outcomes. Transparency could highlight some facts – overhead ratios are a common target of many charity rating organizations – while neglecting other pertinent information, such as the marginal effect of additional overhead or salary on output.[95] Should the designers of a nonprofit legal regime allow themselves to decide when donors are 'wrong', or would that frustrate the point of decentralizing the production of public goods?[96] A compromise position here might be to try to design disclosure regimes that give donors the kinds of information that they would, if fully informed, want to have available.

These observations cover only a fraction of the relationship between law, economics, and labor practices among nonprofit firms. One of us has authored a more comprehensive early overview.[97] One other interesting area, underdeveloped in our view, is the rationale for and effects of exempting charitable volunteers from minimum wage laws.

C. Regulation of Donors

Law and economic perspectives can also offer some useful lessons for the law's treatment of donors. Some of these are straightforward, as in the case of 'self-dealing' or other transactions in which donors seek to make use of charitable assets on their own behalf. From a public finance economics perspective, donors who can make personal use of charitable assets should likely receive reduced or zero subsidies for their contribution. Public subvention of donations aims to correct market failures, but there is no failure in the market for purchases of private goods.[98] Thus, it would waste costly public dollars to grant benefits to 'donors' who continue to make use of charitable assets. There is also the danger that personal use will detract from the public value of the gift.

A more challenging wrinkle, to which law and economics can also offer some assistance, lies in the design of regulations defining and constraining self-dealing. Should these provisions take the form of bright-line 'rules', forbidding certain defined transactions ('no loans between donors and the firm'), or more open-textured 'standards' ('transactions between donors and the firm are permissible if fair to the firm')?

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95 Steinberg (n 76)

96 Galle discusses these problems in greater depth in his individually authored chapter later in this volume.

97 Richard Steinberg, 'Labor Economics and the Nonprofit Sector: A Literature Review' (1990) 19 *Nonprofit and Voluntary Sector Quarterly* 151.

98 More technically, with revenue-neutral and distributionally neutral subsidies, government wishes to subsidize only the portion of a 'donation' that gives rise to positive externalities: Louis Kaplow, 'Optimal Control of Externalities in the Presence of Income Taxation' (2012) 53 *International Economics Review* 487, 488. When a contributor receives only unobservable personal satisfaction as a result of her gift, government theoretically would like to but cannot precisely tailor the amount of its subsidy to match the portion that donor did not internalize. If the contributor receives items of readily ascertainable value, government can more easily trim back its subsidy. Observable but difficult to value return benefits, such as access to religious services or naming rights, fall into a middle category where different legal regimes have taken varying approaches to whether they reduce subsidies for the contributor.

Louis Kaplow provides an important analytical starting point.[99] In his framework, the planner should select the legal approach that minimizes the total social cost involved in ascertaining the law, including both the government's costs of defining and promulgating and private costs of planning and understanding.

US self-dealing law makes considerable use of a formal structure in which there is a background standard, but that standard is largely deemed satisfied if certain procedural steps, such as review by an independent board of directors, are undertaken. Susan Morse offers an interesting analysis of these hybrid structures, showing how they permit a wider menu of trade-offs than the pure rule/standard choice modelled in Kaplow.[100]

A considerably more difficult question is the extent to which law will permit donors to dictate the uses of donated assets. For example, ancient British law – the 'rule against perpetuities' – largely forbade the use of trusts to control a decedent's assets for an indefinite period after death, and this tradition continued in the United States until recent legislative retrenchment in most states. However, the 1601 Statute of Charitable Uses exempted qualifying charitable trusts from the rule against perpetuities, in effect authorizing perpetual charitable trusts. Should donors be able to restrict charitable assets forever? How closely must the firm follow the letter of donor restrictions?

In part, these answers depend on the underlying rationales for granting favourable treatment for charitable contributions, if any such favours exist. If donor autonomy is the law's *sine qua non*, then unlimited restrictions, perhaps subject to constraints for significant negative externalities such as racist trusts ('but not to be leased to any individuals of the negro race' was a common land-use restriction in American trust instruments), may be the logical conclusion. Economists would instead usually consider donor satisfaction as one input into a more general social welfare function. In that view, donor satisfaction is probably a small component of the overall welfare outcome, except to the extent that it affects the donor's willingness to contribute. Otherwise, the donor's preferences for future outcomes accrue only during the donor's life, while the actual social impact of the remaining funds continues as long as the funds last. Over time, the inefficiency of honouring the imperfectly informed and possibly idiosyncratic visions of long-dead donors could greatly outweigh any gains from giving the donor a small sense of satisfaction in contemplating her legacy.

An underappreciated aspect of the law of donors is that donor restrictions almost inevitably empower managers, and restricting managers may give freer rein to donors, so that evaluating any rule is actually a question of comparative institutional competence. Enhanced donor control reduces managerial slack, diminishing agency costs.[101] This is, as we have emphasized, usually an important goal for organizational law. What, however, if managers are more public-regarding or better informed than donors, and we aim to maximize not only donor satisfaction but also total social welfare? Laura Chisolm argues against donor control on the grounds that donated funds

[99] Louis Kaplow, 'Rules Versus Standards: An Economic Analysis' (1992) 42 *Duke Law Journal* 557.

[100] Susan C Morse, 'Safe Harbors, Sure Shipwrecks' (2015) 49 *University of California-Davis Law Review* 1385.

[101] Hansmann (n 69) argues for greater donor control on this basis.

should belong to the public;[102] this is welfare-maximizing, we suggest, to the extent that managers are systematically more likely to serve public goals, or to the extent law can be tailored to minimize donor control in instances where relative managerial advantage is greatest.

This relative-advantage framework deserves greater exploration. At present, there is little theory and essentially no evidence on either side. David Schizer[103] suggests that major donors, whose entrepreneurial backgrounds may distinguish them from the techno-elites that govern major charities, can provide useful information and insights. A similar formulation, grounded in the political theory account of diversity we sketched in section 1C, might suggest that donor control ensures that the distinctive voices of charity supporters are not washed out by managers or manager-friendly courts. On the other hand, the donor class may be more ideologically extreme, and is not directly accountable to competing public views.[104] Law can shape the deliberative processes of managers in ways that help to encourage engagement with rival viewpoints,[105] but it is difficult to imagine how this could be true of donors.

Other major inputs into the social-welfare calculation for donor-control laws are, famously, also unknown. While *cy pres*, the traditional doctrine requiring managers to adhere 'as closely as possible' to donor wishes, was justified as necessary to encourage giving, there has never been any evidence that it does so. In the US, recent state-level reforms liberalizing *cy pres* law were rolled out in different states over a period of years, presenting a possible opportunity for researchers to examine the impact of this natural experiment.

4. SELECTED APPLICATIONS

A. Capital Flows and Firm Size

1. Are nonprofits too small?

For several reasons, nonprofit firms may be smaller than would be optimal under a pure transaction costs approach. Most simply, as Hansmann and others explore, nonprofits lack access to equity markets, preventing efficient expansions or acquisitions.[106] For

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[102] Laura B Chisolm, 'Accountability of Nonprofit Organizations and Those Who Control Them: The Legal Framework' (1995) 6 *Nonprofit Management and Leadership* 141.

[103] David Schizer, 'Subsidizing Charitable Contributions: Incentives, Information, and the Private Pursuit of Public Goals' (2008) 62 *Tax Law Review* 221.

[104] Morris P Fiorina, 'Extreme Voices: A Dark Side of Civic Engagement' in Theda Skocpol and Morris P Fiorina (eds), *Civic Engagement in American Democracy* (Brookings Institution Press 1999). But see Theda Skocpol, 'Advocates Without Members: The Recent Transformation of American Civic Life' in Theda Skocpol and Morris P Fiorina (eds), *Civic Engagement in American Democracy* (Brookings Institution Press 1999), for an argument that it is managers who are more extreme.

[105] Galle (n 34).

[106] Henry Hansmann, 'Reforming Nonprofit Corporation Law' (1981) 129 *University of Pennsylvania Law Review* 497. For a useful recent overview of the relationship between revenues, other resources, and growth, see Georg Von Schnurbein and Tizian M Fritz, 'Benefits

example, a firm that develops valuable intellectual property requiring large capital outlays to bring to market would often be obliged to license that product rather than develop it, as is commonly the case at universities and hospitals. The innovating firm thus must incur the additional transaction costs of the licensing arrangement, including contracting around the possibility that the licensee may choose to simply sit on the license and develop a rival product instead. In other cases, nonprofit firms may have opportunities for expansion that cannot be met by contracting, and simply must leave those opportunities fallow, as in the instance of a service provider in an urbanizing region. Hansmann[107] argues that the lack of equity investors supplies a reason for government to subsidize other revenue sources, such as donations and investment earnings – topics we return to in the next subpart.

While nonprofits by definition cannot issue equity, they can borrow, and the agency costs of debt may be smaller for some nonprofits than for for-profit firms of comparable resources.[108] An important source of tension between creditors and debtors is the divergent risk preferences of the lender and the equity investors.[109] Since the creditor is exposed to downside risk, but holds no upside, the creditor is much more risk-averse than the equity holders. 'Covenants' or contracts between creditors and corporate borrowers aim to minimize this disparity, and sometimes grant the creditor considerable authority, such as the ability to seize control of the firm when the firm approaches insolvency.

The nondistribution constraint reduces this tension between the firm and its creditors. By definition, the returns for the nonprofit firm's stakeholders in taking large financial risks are usually limited. Moreover, nonprofit managers, as salaried employees of the firm, are effectively creditors, aligning their incentives with those of other lenders.

On the other hand, nonprofit stakeholders diverge from the interests of their creditors in ways that are not common among for-profit borrowers. Most obviously, the firm may prioritize outputs other than revenue.[110] In some jurisdictions legal restrictions prevent firms from pledging to prioritize the ability to meet debt payments over the firm's mission. Many jurisdictions also shield assets devoted to charitable purposes from creditors in bankruptcy, such that firms, in effect, have far fewer assets to secure debt than what appears on their balance sheet. Nonprofits cannot issue convertible debt or repurchase it with equity.[111] Finally, nonprofits often have relatively undiversified sources of revenue, increasing creditor risk.[112]

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and Drivers of Nonprofit Revenue Concentration' (2017) 46 *Nonprofit & Voluntary Sector Quarterly* 922.

[107] Hansmann (n 1).

[108] See Gerard J Wedig, Mahmud Hassan and Michael A Morrissey, 'Tax-Exempt Debt and the Capital Structure of Nonprofit Organizations: An Application to Hospitals' (1996) 51 *The Journal of Finance* 1247, for development of an agency-cost theory of nonprofit borrowing.

[109] Jensen and Meckling (n 21).

[110] For evidence that managers dislike yielding autonomy to creditors, see Harvey S Rosen and Alexander JW Sappington, 'To Borrow or Not to Borrow? An Analysis of University Leverage Decisions' (2016) 70 *Research in Economics* 170.

[111] Wedig, Hassan, and Morissey (n 108).

[112] See Karen A Froelich, 'Diversification of Revenue Strategies: Evolving Resource Dependence in Nonprofit Organization' (1999) 28 *Nonprofit and Voluntary Sector Quarterly*

On net, it is unclear whether borrowing is more or less costly in the nonprofit context. In addition to agency cost differences, US nonprofits can issue debt instruments whose interest is exempt from tax, allowing the firm to capture a portion of the exemption's value; however, as Uwe Reinhardt points out, the resulting tax advantage is smaller than the value for-profit firms receive from deducting their bond interest.[113] Thad Calabrese and Todd Ely find that nonprofit bond issues are generally limited to large firms with very low risk of bankruptcy,[114] although firms of all sizes make considerable use of other forms of debt.[115] Frank Sloan summarizes studies finding that, including tax advantages, non-profit hospital borrowing is very moderately cheaper than that of for-profit competitors.[116] If the nonprofit borrowing advantage is modest, borrowing likely cannot make up for the large disadvantage of the absence of equity financing, which suggests that nonprofits on average will be smaller than the Coasian (transaction-cost) optimum.

A second major set of reasons firms might be smaller than optimal relates to their relationship with donors. Firms can obtain free services from volunteers (donors of labour), incentivizing the organization to leave outside the firm services that might be offered voluntarily.[117] Although likely to be beneficial on net, volunteer services are generally less valuable than comparable paid services, as the firm is unlikely to be able to contract with volunteers over the terms of their performance.[118] This may offer a justification for the rule, common in many US jurisdictions, immunizing volunteers from tort liability when in the performance of their volunteer duties.[119] Absent immunity, firms would likely have to indemnify volunteers, but would be unable to readily contract with them to manage the risk of injuring others.[120]

246, for an introduction to the concept of revenue diversification, and Yan Wenli, Denison V Dwight and S J Butler, 'Revenue Structure and Nonprofit Borrowing' (2008) 37 *Public Finance Review* 47, for evidence that diversified revenues increase nonprofit firm borrowing.

[113] Uwe E Reinhardt, 'The Economics of For-Profit and Not-for-Profit Hospitals' (2000) 19 *Health Affairs* 178. Recently enacted US limits on the deductibility of interest payments may shift this calculus, TC 163(j), however.

[114] Thad D Calabrese and Todd L Ely, 'Borrowing for the Public Good' (2016) 45 *Nonprofit and Voluntary Sector Quarterly* 458.

[115] Robert J Yetman, 'Borrowing and Debt' in Dennis Young (ed), *Financing Nonprofits: Putting Theory Into Practice* (AltaMira Press 2007).

[116] Frank Sloan, 'Not-for-Profit Ownership and Hospital Behavior' in Joseph P Newhouse and Anthony J Culyer (eds), *Handbook of Health Economics* (Elsevier 2000) 1165.

[117] As we noted, Coase thought of actors as 'outside' the firm when the firm was obliged to enter the market to transact with them. It is unclear whether he would have thought of the donor-firm relationship as a 'market' transaction. We describe donors as 'outside' the firm because the firm must contract with them on a transaction-by-transaction basis, rather than being able to direct their activity as employees. In essence, donors are 'outside' the firm in the sense that contracting costs with them are higher than would typically be the case in an employer-employee relationship.

[118] Femida Handy and Narasimhan Srinivasan, 'The Demand for Volunteer Labor: A Study of Hospital Volunteers' (2005) 34 *Nonprofit and Voluntary Sector Quarterly* 491.

[119] Jill Horwitz and Joe Mead, 'Letting Good Deeds Go Unpunished: Volunteer Immunity Laws and Tort Deterrence' (2009) 6 *Journal of Empirical Legal Studies* 585.

[120] Jeffrey D Kahn, 'Organizations' Liability for Torts of Volunteers' (1985) 133 *University of Pennsylvania Law Review* 1433.

Given the possible distortions of volunteer labour, it might be thought that donors would contribute cash instead. The reasons donors provide labour rather than property are not fully understood.[121] Some donors, of course, may have more of one than the other. Volunteering may provide benefits to the volunteer, such as human or social capital, that cash contributions would not.[122] Volunteerism can also be a possible response to agency costs, as donated labour is more difficult for managers to divert to non-specified uses. Volunteer labour additionally cannot be easily banked, making it akin to staged financing: the implicit promise of future giving encourages the firm to accede to the donor's wishes.[123] Finally, in tax systems with limited benefits for charitable contributions (for example, US cash donors who opt not to itemize their deductions), the treatment of volunteer labour is tax favoured, in that donors can avoid including the value of their donated labour in income.[124]

Before moving on, it is worth emphasizing that misaligning the boundaries of the firm can have real and important economic effects. Consider the impact of capital constraints on firm incentives to innovate. If firms cannot expand to exploit their innovation, they will be relatively less likely to invest in innovation in the first place (although of course altruistic firms may be willing to share new insights even without protectable property rights). Similarly, if firms must license their invention in order to capture any of its social benefits, the higher transaction costs of licensing operate as a tax on innovation investments. Limits on nonprofit innovation in turn limit the options available to governments seeking to contract out services. Governments and other grant-makers, such as large foundations, may design their awards structures to help make up for these innovation shortfalls, however.[125]

Inefficient firm size also tends to support the claim that nonprofits do not make the best use of their funds. Some commentators have suggested that policy should make space for 'for-profit' charity, on the ground that nonprofits lack incentives to eliminate unnecessary costs.[126] Others observe that there are other potential sources of cost discipline, including managerial commitment and donor scrutiny.[127] Whatever the firm's incentives, however, it may be true that nonprofits incur unnecessary transaction costs.[128]

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[121] Horwitz and Mead (n 119).

[122] See Femida Handy and Laurie Mook, 'Volunteering and Volunteers: Benefit-Cost Analysis' (2011) 21 *Research on Social Work Practice* 412, and Richard Steinberg, 'Economic Theories of Nonprofit Organizations: An Evaluation', in Helmut Anheier and Avner Ben-Ner (eds), *The Study of the Nonprofit Enterprise: Theories and Approaches* (Kluwer/Plenum 2003) 277, for reviews.

[123] Schizer (n 103).

[124] Andrews (n 62). For an argument that donated services should not be included in an ideal tax base, see Simons (n 63) 110–112.

[125] Joel L Fleishman, *The Foundation: A Great American Secret: How Private Wealth Is Changing the World* (Reprint edition, PublicAffairs 2009).

[126] Todd Henderson and Anup Malani, 'Corporate Philanthropy and the Market for Altruism' (2009) 109 *Columbia Law Review* 571; Malani and Posner (n 72).

[127] Galle (n 72); Andrei Shleifer, 'State Versus Private Ownership' (1998) 12 *Journal of Economic Perspectives* 133.

[128] Ballou and Weisbrod (n 81).

2. Are nonprofits too large?

At the same time that nonprofits may sometimes inefficiently leave some relationships outside the boundaries of the firm, other factors may encourage them to inefficiently bring others in house. These two contrasting impulses could offset as to any particular contracting party, but need not. Firms buy some inputs they should make, while also making some different inputs they should buy. In other words, firms may be simultaneously too small in some dimensions and too big in others.

Firms may grow too large because of the lack of market discipline or managerial incentives to maintain optimal size.[129] 'Empire building' is thought to be a common phenomenon among managers of all kinds. In a for-profit setting, however, a firm that is too aggressive in acquiring domains for its managers to rule risks being bought up and divided, often under new management. Similarly, firms often realize a stock-price return for 'spinning off' and divesting themselves of underperforming units, divisions that have diseconomies of scope with other firm components, or portions of the business that are difficult for outside investors to monitor. It is possible that nonprofit managers will recognize and act on problems of these kinds. They lack, however, an equity stake in the company that would more directly incentivize them to maximize shareholder value.

Tax considerations in many jurisdictions also extend the boundaries of the firm. The exact direction and size of the effect is sensitive to many factors, including not only the rules for nonprofit organizations, but also the tax rates applicable to individuals and for-profit businesses.[130] We will summarize some general principles.

Most countries exempt nonprofit organizations from income tax, with two straightforward effects on the boundaries of the firm. First, exempting a firm's profits leaves more retained earnings for the firm to draw on in financing new projects; this may help to counter the firm's inability to issue equity.[131] Second, there is a tax incentive to bring suppliers and service providers inside the legal boundaries of the nonprofit firm, in order to eliminate the tax on their profits.[132] The nonprofit can then capture some of these tax savings. Many regulators have adopted rules, such as taxes on 'unrelated business income', that aim to offset the latter set of incentives; evaluation of these efforts is beyond our scope here.

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129 Howard P Tuckman and Cyril F Chang, 'Nonprofit Equity: A Behavioral Model and Its Implications' (1992) 11 *Journal of Policy Analysis and Management* 76.

130 Michael Knoll, 'The UBIT: Leveling an Uneven Playing Field or Tilting a Level One?' (2007) 76 *Fordham Law Review* 857.

131 Henry Hansmann, 'The Rationale for Exempting Nonprofit Organizations From Corporate Income Taxation' (1981) 91 *The Yale Law Journal* 54.

132 Yair Listokin, 'Taxation and Liquidity' (2011) 120 *Yale Law Journal* 1682. Because of the 'realization' rule, most income tax systems provide a partial version of this incentive even for for-profit businesses. Making inputs rather than buying them offers firms the benefits of deferral to the extent that the end product is sold in a subsequent tax year. For example, suppose Firm A sells widget axles to Firm B in Year One, so that Firm A pays income tax on its profits P_A in Year One. Firm B pays income tax on its widget profits P_B when widgets are sold in Year Two. If Firm B acquires Firm A, it will realize profits $P_A + P_B$, taxable in Year Two. A mark-to-market system of taxation in which Firm B would be taxed on the increase in its value from the profitable manufacture of widget axles in Year One would eliminate this deferral possibility.

More complicated incentives emerge, depending on the relative tax treatment of nonprofits and rival owners of property. In general, if for-profit entrepreneurs are taxed equally on business and portfolio investment income, there is no tax distortion.[133] For-profits will take home less of the value of a business asset than a nonprofit would, but the for-profit's opportunity cost (the after-tax return on a portfolio investment) is also lower. However, if assets are subject to varying tax rates, there will be 'clientele' effects in which tax-exempt nonprofits have a comparative advantage in bidding for higher-taxed assets.[134]

An important example of this phenomenon in the US context is the property tax. State and local governments in the United States collect annual *ad valorem* taxes on real property, but property used for charitable purposes is generally exempt. Charitable organizations, therefore, have a tax advantage in bidding for any given parcel of land. Unless there are large numbers of potential charitable purchasers to bid away that advantage, the result is a subsidy for real estate holdings. US tax law thus encourages nonprofits to prefer real property to alternative assets, to hold real estate rather than rent it, and to favour real estate intensive operations over others (Sjoquist and Stoycheva[135] provide a more comprehensive summary of the theory and evidence on these points).

3. Cash flows

The Coasian boundary can also stretch across time. Donors or grantors may decide not only whether to transfer property to control of a nonprofit firm, but also when to do so. Because of incomplete information and agency slack, the timing of a property transfer represents a trade-off between different sets of transaction costs. Tax rules in many cases will distort the optimal timing of the transfer. These choices can also interact with the decision of whether to make the transfer at all: even the optimal point may be so undesirable that the funder chooses another use for her property.

Agency costs generally favour slow, incremental transfers. A robust finding in the finance literature is that 'staged financing' reduces agency costs among for-profit firms. Managers with access to 'free cash flow' do not have as great a need to satisfy outside funders, while those who must return regularly to equity or debt markets know that their earlier behaviour will establish their trustworthiness (or lack of it) for subsequent funders.[136] Several authors find some weak evidence that free cash flows also increase agency costs in nonprofits.[137] Thus, donors or grantors may prefer staged financing as

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133 Reinhardt (n 113).

134 Knoll (n 130); Listokin (n 132); Myron Scholes and others, *Taxes and Business Strategy: A Planning Approach* (Pearson 2016).

135 David L Sjoquist and Rayna Stoycheva, 'The Property Tax Exemption for Nonprofits' in Bruce Seaman and Dennis R Young (eds), *Handbook of Research on Nonprofit Economics and Management* (Edward Elgar 2010) 303.

136 Michael C Jensen, 'Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers' (1986) 76 *American Economic Review* 323.

137 Galle and Walker (n 79); Woods Bowman, Elizabeth Keating and Mark A Hager, 'Investment Income' in Dennis R Young (ed), *Financing Nonprofits: Putting Theory into Practice* (AltaMira Press 2007).

a tool for controlling nonprofit agents.[138] Donors can also employ other structures, such as 'restricted' gifts, whose uses are limited to specified purposes, or intermediary organizations such as community foundations, to limit managerial slack, but these options generally carry greater contracting and enforcement costs.[139]

There is a trade-off, however, between minimizing managerial flexibility and making best use of the managers' expertise.[140] Firms optimally allocate their resources when they equalize the marginal returns to spending in each time period. Outside funders are unlikely to be able to observe these marginal returns as well as the firm's managers. This opacity has several causes, including that one party may have incentives to only convey information favourable to their interests, that information-gathering is costly, and that some crucial information may be hard to reduce to writing.[141] Thus, if donors and managers had identical preferences, donors would want to rely on managers' superior information to maximize the value of their donation. Transferring funds immediately and allowing the firm's managers to establish an endowment, then allocating a portion of the funds in each period reduces the donor's information problem. Of course, firms with unconstrained borrowing capacity could also achieve this result, but as we have seen, few nonprofits can borrow without limits.

The tax treatment of investment assets can affect funders' choices about when to transfer property to the nonprofit firm. If the funder is taxable but the recipient firm is not, there is a significant tax advantage in having the nonprofit hold any appreciating assets, as this effectively eliminates the tax on gains.[142] In the case of individuals in a regime with a tax on inherited wealth, there is also (in regimes with a deduction for charitable donations) a large tax advantage to bequeathing a portion of the estate to a nonprofit, even if the donor would prefer that the funds be spent well after the time of her death. Both these rules, in other words, encourage donors to transfer assets to donee firms earlier than their preferences would otherwise imply. One of us finds evidence that donors are willing to accept relatively substantial agency costs in order to avail themselves of this income tax avoidance.[143]

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138 Edward L Glaeser, *The Governance of Not-for-Profit Organizations* (University of Chicago Press 2006); Schizer (n 103).

139 John Posnett and Todd Sandler, 'Transfers, Transaction Costs, and Charitable Intermediaries' (1988) 8 *International Review of Law and Economics* 145.

140 Brian Galle, 'Pay It Forward: Law and the Problem of Restricted-Spending Philanthropy' (2016) 93 *Washington University Law Review* 1143.

141 Paul M Healy and Krishna G Palepu, 'Information Asymmetry, Corporate Disclosure, and Capital Markets: A Review of the Empirical Disclosure Literature' (2001) 31 *Journal of Accounting and Economics* 405.

142 Daniel Halperin, 'Is Income Tax Exemption for Charities a Subsidy?' (2011) 64 *Tax Law Review* 283. In the United States, taxable donors can attempt to replicate this tax advantage by holding any appreciated asset until the time of donation. Under US tax rules, there is almost never tax on unrealized gains, and donation is not a realization event. The cost, however, is that the donor is locked into the property, and cannot diversify or switch to a more productive investment. At the margin, we would expect the economic costs of this tax-avoiding strategy to equal any tax advantage. Galle (n 140).

143 Brian Galle, 'Valuing the Right to Sue: An Empirical Measure of Nonprofit Agency Costs' (2018) *Journal of Law and Economics* (in press).

B. Regulation of Capital

1. Accumulation and pay out

Firms typically best serve their goals when they smooth their spending over time, either by borrowing or by saving. That is, all else equal, the likelihood of diminishing marginal returns from organizational expenditures implies that money can productively be transferred from boom years to lean years. This is particularly true of organizations with relatively fixed costs, such as classroom or chapel space, where a sharp revenue contraction would threaten the ability of the firm to carry out its mission. Organizations with inadequate borrowing capacity and limited accumulated reserves are more vulnerable to economic downturns or other unexpected reversals.[144] Firms more generally may use investment income to hedge against other forms of income risk.[145] Thad Calabrese found that most nonprofits held insufficient or nonexistent operating reserves, forcing them to reduce services and lay off workers when the Great Recession began.[146]

Nonprofits that wish to increase their reserves face many challenges.[147] First, funders and other stakeholders may value current expenditures over future solvency.[148] For example, if funders use ratios of program spending to administrative costs as a heuristic for agency costs, and punish low program spending ratios, they will tend to discourage savings as a side effect. Even aside from the ratio issue, asset accumulation may crowd out donations, as some donors may prefer to support needier organizations. Sheena Ashley cites mixed evidence on whether this concern is valid.[149] One Calabrese study found that donors contribute less when reserves exceed two years' funding, with a higher threshold for concern in some subsectors.[150] Another Calabrese study found no such relationship for individual donors, but that government funding is negatively correlated with reserves.[151] Governments may respond with policies that facilitate savings, or alternately could encourage programs to facilitate easier credit.[152]

Other organizations appear to accumulate cash in excess of any reasonable reserve fund.[153] Philanthropic organizations, classically, accumulate large pools of funds and

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144 Henry Hansmann, 'Why Do Universities Have Endowments?' (1990) 19 *Journal of Legal Studies* 3.

145 Dennis R Young, 'Toward a Normative Theory of Nonprofit Finance' in Dennis R Young (ed), *Financing Nonprofits: Putting Theory into Practice* (AltaMira 2007) 339.

146 Thad Calabrese, 'Running on Empty: The Operating Reserves of US Nonprofit Organizations' (2013) 23 *Nonprofit Management and Leadership* 281.

147 Sheena Ashley, 'Inherent System Dynamics of Instability and Resilience in Nonprofit Human Services' in Yilin Hou (ed), *Local Government Budget Stabilization: Explorations and Evidence* (Springer 2015) 191.

148 David Schizer, 'Subsidies and Nonprofit Governance: Comparing the Charitable Deduction with the Exemption for Endowment Income' (15 February 2017) Columbia Law School Working Paper No 558.

149 Ashley (n 147).

150 Thad D Calabrese, 'Do Donors Penalize Nonprofit Organizations with Accumulated Wealth?' (2011) 71 *Public Administration Review* 859.

151 Calabrese (n 146).

152 Galle (n 140) offers several possibilities on the latter front.

153 Hansmann (n 144).

aim to spend them over long periods of time, often described as perpetuity. In the United States, educational institutions also hold large endowment funds, totalling more than $500 billion at recent counting, although these savings are highly concentrated among the very wealthiest institutions.[154] Other jurisdictions, such as the UK and Germany, have reportedly explored mechanisms for encouraging endowment development at their own institutions of higher learning.

Hansmann and Galle each argue that market-failure theories may justify government regulation of 'excessive' nonprofit asset accumulation.[155] This argument rests on the claim that donors, managers, or both make decisions about the timing of expenditures that do not fully internalize the impact of these determinations on others. As such, the argument necessarily depends on the somewhat controversial assumption that regulators should second-guess whether spending decisions by nonprofits are social-welfare maximizing; Galle claims that requiring nonprofits to internalize negative externalities is fully consistent with the 'three failures' rationales.[156] David Schizer also argues for government regulation of endowment spending to correct other distortions created by tax policy.[157]

Under these views, regulators would aim to correct systematic 'failures' in the temporal allocation of assets. Most straightforwardly, spending creates learning externalities for government and other funders, as observers can gather information about the success or failure of a project and apply it to future projects.[158]

Whether other 'failures' should be corrected may depend on the extent to which firms are subsidized by government. Large differences in time preferences between firms and the government planner might argue for rules encouraging firms to better match the planner's preferences. For example, firm and social evaluations may differ because of risk preferences. Firms will choose to spend when the present subjective value from a project exceeds the present value of the lost stream of investment returns, over the relevant time horizon for the firm.[159] Managers, and other major stakeholders (such as college alumni), have large and mostly nondiversifiable investments in individual firms, making them averse to risk. Firms are likely to choose spending rates that minimize the danger of bankruptcy or other major adverse events.[160] Nonprofits

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154 US Department of Education, National Center for Education Statistics, Digest of Education Statistics 2015 Table 333.90, retrieved from <https://nces.ed.gov/programs/digest/d15/tables/dt15_333.90.asp?referrer=report>.

155 Hansmann (n 144); Galle (n 140).

156 Ibid.

157 Schizer (n 148).

158 Galle (n 140).

159 Michael Klausner, 'When Time Isn't Money' (2003) 1 *Stanford Social Innovation Review* 51.

160 Hansmann (n 144). A central planner would also view insolvency as costly in cases where the bankruptcy proceeding results in large transaction costs or waste of purpose-specific assets, such as the conversion of classroom space to retail. This is unlikely to be the case for philanthropic organizations, however.

may also tend to spend more slowly because of informational,[161] psychological[162] or agency slack[163] reasons.

2. Charitable 'conglomerates'

A transaction cost framework can also shed some potential light on whether nonprofits should combine distinct tasks within a single firm.[164] The principal-agent relationship is more complex in firms with multiple goals, especially if those goals are potentially conflicting. A key problem is that some tasks may be easier for principals to monitor or incentivize than others, potentially leading managers to favour the measurable tasks even when they are less important to the principals.[165] In complex settings, multiple tasks may also exceed the available time and attention managers have available.[166]

Incentive pay may be able to overcome these problems, but at times it may instead be optimal to simply divide the firm.[167] If both tasks are reflected in the firm's bottom line, equity pay can help to moderate conflicts. In other cases, however – such as in most nonprofit firms – the only option is to measure the quality of the individual results of each task. If this cannot be done with great precision, and mismeasurement is very costly, one of the tasks should likely be outsourced to other managers.[168]

In nonprofits, multiple tasks raise the further danger of weakening the nondistribution constraint. Again, the nonprofit commitment helps managers to credibly pledge not to divert customer dollars to the enrichment of equity investors. In firms that carry on two tasks, each on its own potentially charitable, managers may have the discretion to cross-subsidize one activity with income from the other.[169] The possibility that resources may be redirected from the project preferred by donors introduces another form of potential contract failure.[170]

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[161] Reinhardt (n 113); Yetman (n 115).

[162] Akash Deep and Peter Frumkin, 'The Foundation Payout Puzzle' in William Damon and Susan Verducci (eds) *Taking Philanthropy Seriously: Beyond Noble Intentions to Responsible Giving* (Indiana University Press 2006) 189; Hansmann (n 144).

[163] Bowman, Keating, and Hager (n 137).

[164] Richard Steinberg, 'Principal-Agent Theory and Nonprofit Accountability', in Klaus J Hopt and Thomas Von Hippel (eds), *Comparative Corporate Governance of Non-Profit Organizations* (Cambridge University Press 2010) 73, summarizes in more depth.

[165] Daron Acemoglu, Micheal Kremer and Atif Mian, 'Incentives in Markets, Firms, and Governments' (2008) 24 *Journal of Law, Economics, and Organization* 273; Bengt Holmstrom and Paul Milgrom, 'Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design' (1991) 7 *Journal of Law, Economics, and Organization* 24; Brian A Jacob and Steven D Levitt, 'Rotten Apples: An Investigation of the Prevalence and Predictors of Teacher Cheating' (2003) 118 *Quarterly Journal of Economics* 843.

[166] Sucheta Nadkarni and Pamela S Barr, 'Environmental Context, Managerial Cognition, and Strategic Action: An Integrated View' (2008) 29 *Strategic Management Journal* 1395.

[167] Bengt Holmstrom, 'The Firm as a Subeconomy' (1999) 15 *Journal of Law, Economics, and Organization* 90; Holmstrom and Milgrom (n 165).

[168] Holmstrom (n 167).

[169] James (n 9).

[170] Avner Ben-Ner, 'Nonprofit Organizations: Why Do They Exist in Market Economies?' in Susan Rose-Ackerman (ed), *The Economics of Nonprofit Institutions: Studies in Structure and Policy* (Oxford University Press 1986) 94; Hansmann (n 1).

These principles suggest that, all else equal, nonprofits should focus on single or complementary tasks. As we have emphasized, nonprofit outputs are difficult to measure, and equity pay is unavailable. Of course, as we have also seen throughout this section, transaction costs are only one consideration in drawing the ideal boundaries of the firm. To add to the list we have already surveyed, overarching mission or efficiencies of scope – cost or quality advantages that arise from bringing two operations together under one roof – may push towards consolidation. In other instances, cross-subsidizing may be exactly the goal, and may be possible due to market conditions.

Consider hospitals. In the USA and Australia, hospitals often provide care to individuals who cannot afford to pay. US nonprofit hospitals cross-subsidize uninsured patients with profits earned from paying customers.[171] Presumably, however, nonprofit hospitals are able to cross-subsidize 'charity care' despite the agency costs we predict here because health-care customers are largely insensitive to price. Price insensitivity may also be a feature of markets for higher education, and could explain the ability of elite research institutions to reap economies of scope from combining research and instruction, despite the possibility that some stakeholders may favour only one of those goals.

5. DISCUSSION AND CONCLUSION

Nonprofit organizations have been poorly understood by voters, legislatures and regulators around the world, but this is beginning to change as the research base grows. The field of law and economics offers some advice and considerable promise for rationalizing policies that tax, subsidize, and regulate nonprofit organizations. Unlike profit maximizers and social planners, nonprofits have a variety of value-laden missions, and the time is ripe to begin a rethink of how plural views of the public good can best be integrated into the social welfare objective of social planners.

[171] Jill Horwitz and Austin Nichols, 'Hospital Ownership and Medical Services: Market Mix, Spillover Effects, and Nonprofit Objectives' (2009) 28 *Journal of Health Economics* 924.