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THE ATTACK ON NONPROFIT STATUS: A CHARITABLE ASSESSMENT

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American nonprofit organizations receive favorable tax treatment, including tax exemptions and tax-deductibility of contributions, in return for their devotion to charitable purposes and restrictions not to distribute profits. Recent efforts to extend some or all of these tax benefits to for-profit companies making social investments, including the creation of the new hybrid nonprofit/for-profit company form known as the Low-Profit Limited Liability Company, threaten to undermine the vitality of the nonprofit sector and the integrity of the tax system.

Reform advocates maintain that the ability to compensate executives based on performance and to distribute profits when attractive investment opportunities are scarce makes for-profit entities more efficient than nonprofit counterparts. Offering more favorable tax treatment to for-profits engaging in charity would encourage greater charitable entrepreneurship, the argument goes, and provide worthwhile competition for the nonprofit sector. As matters stand, however, nonprofits can and occasionally do reward executives with performance-based compensation, and their nondistribution rules impose no obligation to make subpar investments. The existing nonprofit sector is extremely competitive, and the charitable activities of for-profits already receive favorable tax treatment. Going further and offering socially active for-profits the tax benefits equivalent to those available currently to nonprofits would create opportunities for tax arbitrage by providing tax deductions to high-bracket donors and taxable income for lightly taxed recipients. The difficulty of policing lines between nonprofit

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and for-profit activities of the same business entities would entail significant administrative complexity and is unlikely ultimately to succeed. And even should it succeed, the costs of offering new tax benefits to for-profit charities include not only foregone tax revenues, but also spillover effects on the charitable activities of nonprofits.

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INTRODUCTION

Nonprofits are under attack. Tax authorities have increasingly challenged the income tax exemptions and the (often more valuable) property tax exemptions available to many nonprofits.[1] Some policymakers and scholars would weaken nonprofits further, diluting their tax privileges by offering them to for-profit organizations engaging in charitable activities. In this Article, we argue that nonprofit tax treatment should be reserved for nonprofit organizations.

Many observers believe that, despite the good work of nonprofits, they benefit unfairly from an incongruity in the system used to identify eligibility for tax exemptions. Nonprofits qualify for favorable tax treatment by satisfying various criteria, most notably that they do not have shareholders to whom they can distribute profits. This requirement means that for-profits are ineligible for nonprofit tax exemptions. Yet this distinction between non-

1. Nonprofits vary in form and eligibility for various types of tax exemptions. Here we use the term "nonprofit" to mean the class of organizations commonly known among lawyers as "public charities."

profit and for-profit organizational form seems over-strong to some advocates.[2] The requirements for nonprofit federal tax exemption—nonprofits must be both organized and operated for specified charitable purposes[3]—are surprisingly spare. Further, American charities law "is a relatively weak force in the realm of charity operations," offering little guidance to nonprofits regarding how to provide charity.[4] Moreover, nonprofit organizations are far from perfect, at times deploying their resources in ways that fail to advance the public good, and for-profit firms are occasionally willing to operate in ways that advance social welfare at the expense of their own profits.

It is tempting, therefore, to contemplate a radical policy reform in which charitable operations alone define which organizations might receive the benefits of favorable policy treatment. With such a reform, the provision of charitable services, regardless of organizational status, would be the sole criterion for tax and other benefits. The reform, therefore, would permit for-profit firms to receive tax deductions to the extent that they use funds for specified charitable purposes, and deny tax deductions to nonprofit organizations to the extent that they do not.[5]

These same issues are often cast as a different set of policy questions—whether nonprofit organizations merit their special tax status and, if they do, whether specific charitable acts should be required of organizations that enjoy tax benefits.[6] Once tax benefits are contingent on particular acts, it is a short step to contemplate permitting entities that do not qualify as nonprofit organizations nonetheless to enjoy the benefits available to nonprofits, at least insofar as they engage in charitable activities.

There is considerable appeal to these proposals. Rather than toss a tax exemption into an undifferentiated sea of nonprofits and hope for the best, the government can act like a megaconsumer, using its vast purchasing

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2. *See, e.g.*, Press Release, Sen. Chuck Grassley of Iowa, Sen. Grassley works to build confidence in nonprofits with greater transparency (May 29, 2007), *available at* http://grassley.senate.gov/news/Article.cfm?customel_dataPageID_1502=1258.

3. I.R.C. § 501(c)(3) (2006).

4. Evelyn Brody, *The Legal Framework for Nonprofit Organizations*, *in* THE NONPROFIT SECTOR 243, 243 (Walter W. Powell & Richard Steinberg eds., 2d ed. 2006).

5. Although I.R.C. § 501(c)(3) requires that charities be "organized and operated exclusively for" listed purposes, the regulations are less stringent. The regulations clarify that "[a]n organization will be regarded as *operated exclusively* for one or more exempt purposes only if it engages *primarily* in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3)." Treas. Reg. § 1.501(c)(3)–1(c)(1) (2008) (second emphasis added).

6. *Compare* M. Gregg Bloche, *PERSPECTIVE: Tax Preferences For Nonprofits: From Per Se Exemption To Pay-For-Performance*, 25 HEALTH AFF. w304 (2006) (arguing that tax benefits for hospitals and health plans should be tied to certain accomplishment), David A. Hyman & William M. Sage, *PERSPECTIVE: Subsidizing Health Care Providers Through The Tax Code: Status Or Conduct?*, 25 HEALTH AFF. w312 (2006) (advocating linking tax-exemption to conduct), *and* Richard G. Frank & David S. Salkever, *Nonprofit Organizations in the Health Sector*, 8 J. ECON. PERSP. 129, 130 (1994) (noting that, in the health care sector, "the subsidy is generally tied to the nonprofit 'title' rather than specific performance criteria"), *with* Jill Horwitz, *PERSPECTIVE: Nonprofit Ownership, Private Property, And Public Accountability*, 25 HEALTH AFF. w308 (2006) (advocating linking tax-exemption to status).

power to buy the public goods that it wants.[7] And, according to proponents,[8] if the government is wise enough to contract with for-profit organizations, it can harness private sector incentives and market competition—which, at least until recently, seemed to have desirable effects.

State and federal government actors have found at least some of these ideas persuasive, perhaps in part because of recent political concerns about the insufficiency of charitable activity by *nonprofit* organizations. As a result of these concerns, the Internal Revenue Service ("IRS") and state tax agencies are once more tweaking exemption requirements for nonprofits to better monitor their provision of charity.[9] The United States is hardly alone in this endeavor; the United Kingdom recently implemented major reforms to its charity laws, adding specificity to the public benefit requirement that likely predates the Statute of Elizabeth (1601).[10] (One might think that after hundreds of years of study and practice, Western governments would have answers to questions about the extent to which organizations should be favored based on their charitable status, but easy answers have been elusive.)

Some state governments have taken reform one step further toward the creation of for-profit charities, embracing what is known as "social entrepreneurship," the blending of for-profit incentives with charitable ends.[11] A prominent example is the creation of a new corporate form, the Low-Profit Limited Liability Company ("L3C"). As we explain below, this example highlights some of the risks associated with diluting the significance of nonprofit status and, properly interpreted, points to ways in which the nonprofit form may be more amenable to the use of incentives than is often assumed.

Another recent development is scholarship endorsing new legal forms to ease the provision of for-profit charity. Of particular note is the publication of Professors Anup Malani and Eric Posner's provocatively entitled article

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7. This is the standard economic approach to public-good provision. *See, e.g.*, Paul A. Samuelson, *The Pure Theory of Public Expenditure*, 36 REV. ECON. & STAT. 387 (1954).

8. For a survey of evidence and arguments in favor of contracting with for-profit providers, and balanced thoughts on when it is more and less warranted, see Jonas Prager, *Contracting Out Government Services: Lessons from the Private Sector*, 54 PUB. ADMIN. REV. 176 (1994).

9. For example, the Internal Revenue Service ("IRS") recently redesigned Form 990, the form used by nonprofit tax filers, to require more specificity in reporting charitable activities. Press Release, IRS, IRS Releases Final 2008 Form 990 for Tax-Exempt Organizations, Adjusts Filing Threshold to Provide Transition Relief (Dec. 20, 2007), *available at* http://www.irs.gov/newsroom/article/0,,id=176722,00.html.

Sen. Charles E. Grassley (R-Iowa) recently announced that he would introduce legislation defining specific, bright-line standards for tax exemption. John Reichard, *Grassley: 'Bright Line Test' Needed for Hospital Tax Exemption*, CONG. Q. HEALTHBEAT, Oct. 15, 2008.

10. The preamble to the Statute of Charitable Uses, also known as the Statute of Elizabeth, enumerates permissible charitable purposes. 43 Eliz., c. 4 (1601). The Act was first passed in 1597, 39 Eliz., c. 6, but the later act, which includes "unimportant amendments," is typically cited. *See, e.g.*, W.K. JORDAN, PHILANTHROPY IN ENGLAND, 1480–1660, at 112 (1959). For discussion of the statutes and the enumerated permissible purposes, see Jill Horwitz, *Nonprofits and Narrative: Piers Plowman, Anthony Trollope, and Charities Law*, MICH. ST. L. REV. (forthcoming 2010).

11. For discussion of related developments, see ANDREW WOLK, ASPEN INSTITUTE, ADVANCING SOCIAL ENTREPRENEURSHIP: RECOMMENDATIONS FOR POLICY MAKERS AND GOVERNMENT AGENCIES (2008).

"The Case for For-Profit Charities."[12] The article promises a break from the familiar debate about the merits of conditioning charitable tax exemption on charitable status or contracts for charitable behavior. Instead, following a path taken by other analysts who assume that for-profit organizations are more efficient than nonprofits,[13] Malani and Posner argue that "there is no reason to condition the tax subsidy for charitable activities on organizational form."[14] They offer a litany of benefits of for-profit ownership and, by implication, the costs of nonprofit ownership. Although appealing on first reading, careful examination of the arguments raises questions about their economic foundations, and helps illuminate why the article's policy recommendation—making subsidies available to organizations of any type that provide desirable and measurable public benefits—is considerably less sound than the current regime of restricting tax benefits to organizations with nonprofit status.

Why deny for-profits the opportunity to compete with nonprofits on equal terms? What if both pursue (at least in part) the same goals? One reason is that, as a realistic matter, it is almost impossible to administer a system that ties tax benefits to public benefit provision levels. Leaving aside whether a practical system could be designed, however, such a system would create significant tax avoidance opportunities for self-interested taxpayers. Symmetric treatment of nonprofits and for-profits requires permitting tax deductible contributions to for-profit entities undertaking charitable activity. This, in turn, permits taxpayers to claim deductions for indirect gifts to owners of companies with charitable impulses, thereby undercutting the current nondeductibility of gifts and creating tax arbitrage opportunities whenever donors are in higher tax brackets than donees. Consequently, symmetric treatment of nonprofits and for-profits would be accompanied by significant tax planning opportunities and tax base erosion.

Even so, might the costs of tax avoidance be worth the benefits of conditioning charitable exemption on behavior, regardless of ownership? Since the potential benefits are so modest, we think that they would not. First, the relevant compensation structures and other methods that for-profit firms use to create productivity incentives are already available to nonprofit organizations. However, on the whole they appear less valuable for social enterprise, as evidenced by how infrequently they are used. Perhaps more important, given the competitive nonprofit environment, it is unlikely that nonprofit

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12. Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 93 VA. L. REV. 2017 (2007); *see also, e.g.*, Hadley Rose, Comment, *The Social Business: The Viability of a New Business Entity Type*, 44 WILLAMETTE L. REV. 131 (2007).

13. *See, e.g.*, Dennis R. Young, *Alternative Perspectives on Social Enterprise*, *in* NONPROFITS & BUSINESS 21, 44 (Joseph J. Cordes & C. Eugene Steuerle eds., 2009); THOMAS J. BILLITTERI, ASPEN INSTITUTE, MIXING MISSION AND BUSINESS: DOES SOCIAL ENTERPRISE NEED A NEW LEGAL APPROACH? 3 (2007), *available at* http://www.aspeninstitute.org/sites/default/files/content/docs/pubs/New_Legal_Forms_Report_FINAL.pdf; Bloche, *supra* note 6, at w304–07; Hyman & Sage, *supra* note 6, at w312 (asking whether it makes "any sense to subsidize some health care providers by exempting them from federal, state, and local taxes, based solely on institutional status").

14. Malani & Posner, *supra* note 12, at 2023.

organizations would provide more efficient or better provision of charity if exposed to bracing competition from expanded social entrepreneurship by for-profit firms. Using realistic assumptions about nonprofit markets, we identify advantages of the current system that links ownership status with tax benefits.

Part I of the Article provides background on nonprofits and how they differ from for-profit firms. Part II considers the concept of for-profit charities, describing recent legal developments regarding nonprofit/for-profit hybrids and summarizing the case for for-profit charities. Part III identifies and challenges the commonly advanced, yet ungrounded, assumptions that (1) for-profits are more efficient than nonprofits, and (2) the law forbids nonprofits from using compensation practices that increase efficiency. It further suggests that critics of the nonprofit form often analyze nonprofits in isolation, rather than as organizations that operate in markets. A more realistic representation—one that abandons the notion that for-profits operate in robustly competitive markets while nonprofits do not compete at all—helps clarify the distinction between ownership characteristics and industry characteristics. In Part IV, we offer a detailed response to critiques of current justifications for linking charitable status and tax benefits, and in Part V we consider some of the unintended, and concerning, tax consequences of for-profit charities. We conclude by considering the implications of these arguments for a normative evaluation of for-profit charities.

I. THE NONPROFIT FIRM

Laws from various doctrinal areas and levels of government regulate nonprofit organizations, including the common law of trusts and property, tax law, state business and nonprofit codes, as well as formal and informal powers held by state attorneys general.[15] The absence of shareholders is the first among several features that distinguish nonprofits from for-profits; nonprofit organizations may have members and other stakeholders, but may not distribute profits to any owner. This means that their directors and managers may dictate the use of nonprofit assets, but may not personally profit from those assets.[16]

Beyond this, it is notoriously difficult to characterize nonprofits.[17] Nonprofits include familiar organizations such as the Salvation Army or the Girl Scouts, as well as churches, synagogues, mosques, the National Football

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15. For a comprehensive review of these laws, see MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION (2004). For a more brief review of the laws, see Jill R. Horwitz, *Why We Need the Independent Sector: The Behavior, Law, and Ethics of Not-for-Profit Hospitals*, 50 UCLA L. REV. 1345 (2003).

16. Richard Steinberg & Walter W. Powell, *Introduction*, *in* THE NONPROFIT SECTOR, *supra* note 4, at 1 (citing Avner Ben-Ner & Derek C. Jones, *Employee Participation, Ownership, and Productivity: A Theoretical Framework*, 34 INDUS. REL. 532 (1995)).

17. *See* Michael C. Hone, *Aristotle and Lyndon Baines Johnson: Thirteen Ways of Looking at Blackbirds and Nonprofit Corporations—The American Bar Association's Revised Model Nonprofit Corporation Act*, 39 CASE W. RES. L. REV. 751, 755–56 (1989).

League, and, until recently, the New York Stock Exchange. Health service organizations, such as hospitals and nursing homes, account for 59 percent of total nonprofit spending, with educational organizations accounting for an additional 17 percent.[18] In fact, the majority of nonprofit revenues comes from fees for services rather than donations or grants.[19] In addition, state law generally requires nonprofits to identify a charitable mission in their organizing documents and operate in furtherance of that mission, restricts distribution of assets to other charities upon dissolution, and invests oversight authority in the state attorney general.[20]

This Article is concerned most directly with whether for-profits should be afforded nonprofit tax privileges.[21] At issue are two federal tax provisions available to eligible nonprofits, one that exempts from tax most net income that they earn, and one that permits donors to deduct their contributions.[22] Individual tax filers must itemize their deductions to benefit from charitable contributions, and little more than one-third of American taxpayers itemize.[23] Contribution limits further restrict the tax benefit, and the tax benefit associated with taking a charitable deduction equals the product of the taxpayer's marginal tax rate and the amount contributed.[24] Despite these limitations, the Office of Management and Budget estimates that American individuals and corporations together received roughly $46.6 billion of tax

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18. These percentages are based on spending reported to the Internal Revenue Service for tax year 2004 as reported by Paul Arnsberger, *Charities, Social Welfare, and Other Tax-exempt Organizations, 2004*, STAT. INCOME BULL., Fall 2007, at 210, 213. Figures for other recent years show similar dominance of the nonprofit sector by health and educational organizations. *See* IRS.gov, *SOI Tax Stats—Charities & Other Tax-Exempt Organizations Statistics*, http://www.irs.gov/taxstats/charitablestats/article/0,,id=97176,00.html (last visited Oct. 19, 2009).

19. Elizabeth T. Boris & C. Eugene Steuerle, *Scope and Dimensions of the Nonprofit Sector*, *in* THE NONPROFIT SECTOR, *supra* note 4, at 66, 77.

20. *See, e.g.*, CAL. CORP. CODE §§ 5110–6910 (West 1990); MASS. GEN. LAWS ch. 180, § 4 (2008); MICH. COMP. LAWS ANN. § 450.251 (West 2008) (requiring attorney general approval for dissolution of Michigan nonprofits); *id.* § 450.2855 (requiring that nonprofit articles include a plan for distribution of assets to satisfy debts and then to other charity or government organizations, with similar purpose).

21. States generally follow federal law, exempting organizations, mainly charities, from state income, sales, and property taxes. These state tax benefits are likely more valuable than the federal benefits that attract so much academic and political attention.

22. I.R.C. § 501(c)(3) (2006); I.R.C. § 170(a).

23. Sean Marcia & Justin Bryan, *Individual Income Tax Returns, 2005*, STAT. INCOME BULL., Fall 2007, at 5, 8 (reporting that 36.9 percent of U.S. individual income tax filers itemized their deductions in tax year 2005).

24. Individual taxpayers are not entitled to take tax deductions exceeding 50 percent of their adjusted gross incomes, and certain categories of property are subject to more stringent limits described in I.R.C. § 170(b). The tax benefit provided in I.R.C. § 170 consists of reducing taxable income by the permitted amount of the contribution, which in turn reduces tax obligations by the product of the reduction and the taxpayer's marginal tax rate. Thus, for example, a taxpayer with $100,000 of income and without any deductible contributions might owe $18,000 in federal income taxes. The same taxpayer with $2,000 of deductible contributions and facing a 25 percent marginal tax rate (though a lower average tax rate, reflecting the progressivity of the federal income tax rate schedule) would pay only $17,500 in federal taxes.

savings from charitable contributions in 2007.[25] Of this amount, the tax benefit for donations to educational institutions accounts for $4.3 billion, donations to health organizations account for another $4.3 billion, and the rest, primarily religious organizations, account for $38.2 billion. Donations to for-profit corporations are not eligible for this favorable treatment.

Even with these exemptions and deductions, no nonprofit is completely exempt from taxation, since all are subject to the federal unrelated business income tax,[26] and many make payments in lieu of taxes or other fees for services provided by local governments. Many categories of nonprofits are eligible for federal income tax exemptions, while fewer are eligible to receive tax-deductible donations. With the exception of churches and very small nonprofits, organizations to which contributions are tax deductible must be certified by the IRS and most—though not all—are described by I.R.C. 501(c) (3) (addressing organizations commonly thought of as charities), 501(c)(13) (addressing cemetery companies), and 501(c)(19) (addressing veterans' organizations). Most organizations described by other I.R.C. 501(c) sections are tax exempt but do not, with some exceptions, receive tax-deductible contributions. For example, individual contributions to 501(c)(4) social welfare organizations or 501(c)(6) organizations such as chambers of commerce are not tax-deductible, but business contributions may qualify for expense deductions.

II. FOR-PROFIT CHARITIES: RECENT EXAMPLES AND THE CASE FOR EXPANSION

An organization need not have nonprofit status in order to undertake charitable activity. A for-profit company may donate to a charity and, consequently, receive a tax break for doing so. In fact, although corporate giving decreased considerably in 2008, it still amounted to $14.5 billion, or 5 percent of all charitable giving.[27] Many for-profits participate in cause-related marketing, some of whom build their missions around the pursuit of social causes. The Working Assets phone company, which recently changed its name to CREDO, distinguishes itself as "the only phone company calling

25. U.S. OFFICE OF MANAGEMENT AND BUDGET, BUDGET OF THE UNITED STATES GOVERNMENT: ANALYTICAL PERSPECTIVES 288–91 (2008).

26. So-called unrelated business income is subject to taxation at normal corporate rates, though in practice the unrelated business income tax collects extremely little income each year. *See, e.g.*, Margaret Riley, *Unrelated Business Income Tax Returns, 2004*, STAT. INCOME BULL., Winter 2008, at 76, 76–104 (reporting that all nonprofit organizations together paid only $368 million of unrelated business income tax in 2004). For evidence of paltry unrelated business income tax payments in other years (and the determinants of taxable incomes of nonprofit organizations), see James R. Hines Jr., *Non-Profit Business Activity and the Unrelated Business Income Tax*, *in* 13 TAX POLICY AND THE ECONOMY 57 (James M. Poterba ed., 1999).

27. Press Release, Giving USA Found., U.S. charitable giving estimated to be $307.65 billion in 2008 (June 10, 2009), *available at* http://www.philanthropy.iupui.edu/News/2009/docs/GivingReaches300billion_06102009.pdf.

for a special prosecutor to investigate crimes of torture committed during the Bush administration."[28]

For-profit companies can release their employees to provide free labor for charitable causes. Community service is a part of the corporate mission of Timberland, an outdoor-gear company. It regularly releases its employees to rebuild playgrounds and engage in other community-development projects.[29] For some, these unremunerated for-profit efforts do not go far enough. In this Part, we outline recent developments in for-profit philanthropy and the extension of the trend into new legal forms. We then outline a case for extending nonprofit tax benefits to for-profits that provide charity.

A. *Existing For-Profit Charities and New Hybrid Form*

Although there is only one prominent example of a for-profit charity, Google.org, there is a densely filled continuum of ownership types ranging from what one would think of as pure charities to wantonly profit-maximizing corporations. Google.org is distinct in that although its mission—addressing climate change, poverty, and emerging disease[30]—is typical of a charity, it retains rights unavailable to nonprofits, such as the rights to distribute to its shareholders any profits earned along the way and engage in unlimited lobbying of public officials.[31] It is like a nonprofit in that it makes grants to nonprofit organizations that advance its mission, but, unlike a nonprofit, it also makes equity investments in for-profit companies as part of its main mission (an activity that, if it were a nonprofit, might run afoul of the nonprofit commerciality doctrine). In addition, unlike traditional nonprofits, returns on Google.org's investments may benefit Google Inc.,[32] a for-profit entity. In fact, in its request for proposals for its RechargeIT program, Google.org restricted its investments to for-profits.[33]

Charity-minded for-profits need not adopt a purely charitable mission, like Google.org. They may instead pursue charitable ends, and signal those ends to consumers, by voluntarily adopting some of the restrictions more commonly imposed on nonprofits. For example, the 501(c)(3) charity B-lab certifies that its member ("B") corporations, all of which are for-profit

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28. Working Assets, Frequently Asked Questions, http://www.workingassets.com/FAQs.aspx (last visited Oct. 19, 2009).

29. *See* Timberland, Corporate Social Responsibility Strategy, http://timberland.com/corp/index.jsp?page=csr_strategy (last visited Oct. 19, 2009).

30. Google.org, http://www.google.org/ (last visited Oct. 19, 2009).

31. For a discussion of Google.org's legal privileges, such as unlimited lobbying, see Dana Brakman Reiser, *For-Profit Philanthropy*, 77 FORDHAM L. REV. 2437 (2009).

32. *Id.* at 2454–59.

33. RechargeIT.org, RechargeIT Request for Investment Proposals, http://www.google.org/recharge/rfp (last visited Oct. 19, 2009) ("This RFP is focused exclusively on investments in for-profit companies. This RFP builds on a series of earlier grants for non-profits and policy work announced by Google.org as part of the RechargeIT initiative in June 2007. We may fund additional proposals in support of policy, R&D and other related work by non-profits, but that is not the focus of the current RFP.").

entities, adhere to its social and environmental standards.[34] Although the certification is done through a private, rather than a government, entity, the members must amend their governing documents to incorporate the interests of employees, community, and the environment as well as shareholders. B Corporations include Dansko (a shoe manufacturer), Impact Makers (a non-stock management consulting firm), Seventh Generation (a household products manufacturer), and Mugshots (a self-described "socially conscious" café serving fair-trade drinks and local foods in Philadelphia).[35]

In addition, the law currently allows for "social enterprise," the harnessing of profit-making organizations in the service of fully charitable ends. The Tax Reform Act of 1969 permits private foundations to merge their investing and program functions to make Program Related Investments ("PRIs").[36] A PRI is a combination of a grant and an investment—e.g., a below-market loan for micro-development purposes—that counts towards the minimum annual required foundation payout and allows the foundation to receive a return on the investment.[37]

Another example of the concept of for-profit charities can be found in recent calls for authorizing new hybrid companies that might "accept foundation grants and tax-deductible contributions that would be segregated on the books and used only for charitable purposes."[38] In fact, private foundations may already invest in commercial for-profits provided they follow stringent "expenditure responsibility" rules to ensure that the funds are not used for for-profit purposes.[39] For example, the IRS has permitted the Gates Foundation to invest in for-profit pharmaceutical companies to help reach its goal of reducing disease in developing countries.[40] As such, it is an example of private philanthropy harnessing the private, for-profit sector for public ends while maintaining its promise to reinvest any profits in charitable production. Due both to prevailing regulations and to the creativeness of enterprise, this mixture of nonprofit and for-profit action does not require the existence of organizations that themselves embody both nonprofit and for-profit forms.

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34. B Corporation, http://www.bcorporation.net (last visited Oct. 19, 2009).

35. *Id.*

36. For a detailed overview of PRIs, see James P. Joseph & Andras Kosaras, *New Strategies for Leveraging Foundation Assets*, 20 TAX'N OF EXEMPTS 22 (2008). For the necessity of new legal structures to allow social entrepreneurship, see BILLITTERI, *supra* note 13, *passim*.

37. I.R.C. § 942 requires private nonoperating foundations to disburse at least 5 percent of their assets annually or face a draconian penalty tax. I.R.C. § 942 (2006). I.R.C. § 945 cites PRIs as an exception to the rule prohibiting foundations from making risky investments that jeopardize a foundation's charitable purpose. I.R.C. § 945 (2006).

38. BILLITTERI, *supra* note 13, at 7.

39. Treas. Reg. § 53.4945-5(b)–(e) (2008).

40. In a Private Letter Ruling, the IRS permitted the foundation to make program-related investments in private, for-profit industry to accelerate the discovery, development, and adoption of health interventions to reduce disease in developing countries. I.R.S. Priv. Ltr. Rul. 200603031 (Jan. 20, 2006).

Some states, however, have gone further in permitting for-profit charitable activity. Vermont recently made a variant of such investing easier by authorizing a new corporate form, the L3C. The L3C is the first formal nonprofit/for-profit hybrid. The authorizing statute requires that it: (1) must significantly further charitable or educational purposes as defined by the I.R.C. § 170(c)(2)(B), (2) would not have been formed but for that purpose, and (3) must not have as a significant purpose to produce income or appreciation of property, although evidence of producing significant income or capital appreciation is not conclusive evidence of such a purpose.[41] Since the L3C is taxed like any other limited liability company, the entity does not pay federal income tax; instead, its net income is allocated among the members who, unless themselves exempt organizations, presumably are taxed on this income. It is unclear whether such an entity would pay local property tax if it owned property.[42]

Creation of the L3C structure is a step in the direction of facilitating the creation of for-profit charities. Although the statute was designed to encourage foundation investment, there is no reason why individuals or business entities such as corporations or limited liability companies could not invest in an L3C. One of the main proponents of the L3C form envisions just this, suggesting that foundations would hold the highest level of investor risk and demand the lowest return, allowing other investors to accept less risk but also to "accept some of its return in the form of enhanced social welfare."[43]

The investor in this case is not entitled to an explicit charitable tax deduction for the financial return she forgoes in exchange for enhanced social welfare, though it does not follow that the tax system fails to subsidize an investment directed at social welfare rather than market returns. Investors receive implicit deductions in the sense that their taxable incomes are reduced when the L3C invests in charitable or educational activities that generate below-market financial returns; as is well known, the tax system effectively subsidizes any investments that produce subpar returns, whether or not undertaken with social goals in mind.[44] Stated another way, there is no tax on the pleasure that comes from making an investment that advances

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41. VT. STAT. ANN. tit. 11, § 3001(27) (Supp. 2008).

42. Title 32, chapter 125 of the Vermont Code concerning state and local tax exemptions does not address the treatment of L3Cs. Property must be dedicated unconditionally to public use, its primary use must benefit an indefinite class of the public, and it must be owned and operated on a nonprofit basis to benefit from tax exemption. Am. Museum of Fly Fishing, Inc. v. Manchester, 557 A.2d 900 (Vt. 1989). According to Suzanne Montie of the Vermont Department of Taxes in the state Agency of Administration, it is unclear whether a L3C holding real estate would be granted property tax exemption. Letter from Suzanne Montie to Jill Horwitz, Professor of Law, University of Michigan (August 2008).

43. Americans for Community Development, http://americansforcommunitydevelopment.org/faqs.html (last visited Oct. 19, 2009) (question no. 6).

44. The nature of the indirect tax subsidy for charitable activity is that the alternative—crass profit-making—is afforded much less favorable tax treatment, because income is subject to taxation under I.R.C. § 61. I.R.C. § 61 (2006). Whether the tax system can be said to "subsidize" charitable activity in such a case may depend on one's point of view, though what is clear is that the system treats these alternatives differently.

charitable goals, whereas the commercial alternative generates a return that the government taxes. The tax benefits would be greater still if investors were permitted full deductions for their investments in social purposes, but investors nonetheless reap a substantial portion of the tax benefits available to nonprofits simply by virtue of not having to pay taxes on returns that they have not earned.

B. *For-Profit Charities*

Some scholars and advocates have recently argued that advances in for-profit charity like those discussed above do not go far enough. They endorse the creation of new legal forms or new legal entitlements that encourage the blending of nonprofit purposes with for-profit form. In his Nobel Peace Prize lecture, for example, Professor Muhammed Yunus called for the creation of a new legal form to better account for charitable businesses:

> Once social business is recognized in law, many existing companies will come forward to create social businesses in addition to their foundation activities. Many activists from the non-profit sector will also find this an attractive option. Unlike the non-profit sector where one needs to collect donations to keep activities going, a social business will be self-sustaining and create surplus for expansion since it is a non-loss enterprise. Social business will go into a new type of capital market of its own, to raise capital.[45]

In a student note drawing on the example of the micro-lending project for which Yunus and the Grameen Bank won the Nobel Peace Prize in 2006, Hadley Rose worried that without changes in the law, worthy micro-lending operations abroad like Grameen would fall afoul of U.S. nonprofit tax laws "including the exempt purpose requirement, the commerciality doctrine, the private benefit doctrine, the prohibition against certain joint ventures, the Unrelated Business Income Tax ("UBIT"), and the Excess Benefit Tax (EBT)."[46] She recommends a new legal form that would encourage nonprofit business and concludes that "[c]harity law in the US is in need of a paradigm shift by which we encourage business-oriented solutions to poverty and social problems, and the creation of a new legal form of business could precipitate this paradigm shift."[47] Citing Yunus, Rose envisions that this new social business type will attract new types of entrepreneurs:

> [These entrepeneurs] will have not only a profit motivation, but also a motivation to promote social benefits in the world.
>
> These dual motivations will spawn a "social business enterprise," which will essentially operate under the constructs of both a corporation and a

45. Muhammad Yunus, *Nobel Peace Prize 2006: Nobel Lecture*, 13 LAW & BUS. REV. AM. 267, 272 (2007).

46. Rose, *supra* note 12, at 134.

47. *Id.* at 135.

> nonprofit organization. The social business "*may or may not earn profit*, but like any other businesses they must not incur losses."[48]

Since it is not clear that the lack of a hybrid legal form has posed a problem for the Bank—Rose notes that the Bank has been a big success in terms of profits and fruitful partnerships with other for-profits[49]—she implies that it is wrong for shareholder businesses owned by poor people to be taxed.[50]

In *Uncharitable: How Restraints on Nonprofits Undermine Their Potential*, Dan Pallotta, founder of the company that created the successful AIDS rides and Breast Cancer 3-day events, uses the Grameen Bank as an example in arguing that nonprofits are unduly hampered because they are denied the business tools available to for-profits.[51] He complains that unlike the Grameen Bank that operates in Bangladesh, the U.S.-based Grameen Foundation, "cannot raise capital in the stock market to increase its ability to provide capital."[52] More generally, Pallotta explains that in every dimension—from executive pay to advertising to raising capital—nonprofits would be better off if they could act more like for-profits. Moreover, public policies and our culture of nonprofits not only makes nonprofits ineffective and inefficient, but immoral.[53]

As noted above, Professors Malani and Posner have recently argued that federal, state, and local tax exemptions and donation deductibility should be afforded to for-profit firms that produce the types of goods produced by nonprofits. They observe that for-profit firms provide a large number of community-benefit goods and services, and argue that they should be rewarded with tax benefits for doing so.[54] They explain that even if such

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48. *Id.* at 150.

49. *See id.* at 149.

50. *See id.* at 150.

51. DAN PALLOTTA, UNCHARITABLE: HOW RESTRAINTS ON NONPROFITS UNDERMINE THEIR POTENTIAL 2008.

52. *Id.* at 13.

53. *E.g.*, *id.* at 17. In fact, Pallotta implies that if nonprofits were permitted to more fully embrace capitalism, we could solve our social problems such as hunger on earth, cancer, AIDS, and other causes of human suffering. *Id.* at 3.

54. *See, e.g.*, Malani & Posner, *supra* note 12, at 2022, 2062–64. The article also cites Matthew J. Kotchen, *Green Markets and Private Provision of Public Goods*, 114 J. POL. ECON. 816, 817 (2006), for evidence of the prevalence of environmentally friendly goods produced by for-profit firms. But Kotchen shows that the introduction of green goods can reduce social welfare relative to a setting in which for-profit firms do not produce green goods and nonprofit environmental organizations receive contributions from private individuals who want to promote environmental protection. According to Kotchen, "[p]erhaps the most counterintuitive possibility is one in which the green market makes every individual worse off. Figure 3 illustrates an example [where] equilibrium provision decreases . . . and the reduced spill-ins generate negative income effects for both individuals. But in this case the positive income effects from the lower price of [the characteristic which is rival in consumption] are not large enough to be offsetting." *Id.* at 829. Kotchen demonstrates that reductions in aggregate welfare due to the green market are dependent on various features that may in fact be common in green markets, such as lower initial consumption of the private characteristic. Thus the introduction of shade-grown coffee or green electricity can reduce not only direct donations to preserving rainforests or offsetting climate impacts, but also total preservation or offsetting, and actually make all of society worse off (in part because coffee and electricity, the private characteristics bundled in those impure public goods, represent a small part of total consumption). *Id.*

for-profits have shareholders or compensate employees through profit-sharing, their activities would serve the public interest.[55] Like other observers,[56] Malani and Posner assume that for-profit legal structures cause greater efficiency than nonprofit structures. More specifically, they theorize that for-profits are more efficient than nonprofits because of intrinsic differences in their compensation schemes. Owners and executives of for-profit firms generally receive performance-based compensation, which both motivates high levels of attention and effort and attracts managers who are confident in their capabilities. These benefits of performance-tailored compensation are presumably lost if managers are paid like bureaucrats, which is generally not true of the corporate sector of U.S. businesses,[57] but may be characteristic of nonprofits. The heart of their article, which we describe in great detail below, does not build an affirmative case for for-profit charities. Rather it describes, and finds wanting, stylized versions of five common justifications for granting nonprofit organizations special tax status: (1) public goods, (2) agency, (3) altruism, (4) imperfect consumers, and (5) administrability. Before turning to the merit of these justifications for nonprofit tax exemption, we address some assumptions that motivate the calls for for-profit charity.

III. INVESTIGATING THE ASSUMPTIONS: EFFICIENCY AND COMPENSATION

Commentators frequently assume that "[n]onprofits are inherently less efficient than for-profit businesses."[58] This generally reflects a faith in the purifying effects of market competition, which is thought to be stiffer in the case of for-profit markets than in nonprofit markets. There is also an unreflective and widespread use of business terminology in the charitable sector, reflecting the belief that for-profits are more efficient than nonprofits.

According to David Pozen, commentators understand "social entrepreunership" as involving "a nonprofit organization adopting business

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55. The article is silent on whether for-profit charities would be subject to the same oversight and restrictions as nonprofit charities, such as attorney general oversight, *cy pres* proceedings, state fundraising restrictions, and federal lobbying restrictions.

56. *See, e.g.*, BILLITERI, *supra* note 13, at 2 (stating that the nonprofit world "often lacks the market efficiencies of commercial enterprise"); Avner Ben-Ner & Benedetto Gui, *Introduction*, *in* THE NONPROFIT SECTOR IN THE MIXED ECONOMY, 11 (Avner Ben-Ner & Benedetto Gui eds., 1993) (noting that "[i]n perfectly competitive markets with no externalities and with symmetric information nonprofit behavior is suboptimal relative to for-profit behavior"); David Easley & Maureen O'Hara, *The economic role of the nonprofit firm*, 14 BELL J. ECON. 531, 532 (1983) (analyzing a model in which the nondistribution constraint makes nonprofits inefficient).

57. *E.g.*, Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?* 113 Q.J. ECON. 653, 654 (1998).

58. Jeremy Benjamin, Note, *Reinvigorating Nonprofit Directors' Duty of Obedience*, 30 CARDOZO L. REV. 1677, 1679 n.12 (2009) (noting that "[o]nly where consumers require additional protections that nonprofits supply—such as in the case of securing public goods or supplying third parties with aid—is a nonprofit the preferable model"). Henry Hansmann offers a more balanced assessment, noting that the relative efficiencies of nonprofits and for-profits "depend[] upon the factors that actually motivate the managers of for-profit and nonprofit firms." Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE. L.J. 835, 878 (1980).

best-practices and a business mindset, and maybe also starting a for-profit offshoot, to become more efficient, effective, and sustainable in the pursuit of its traditional objectives."[59] Or, alternatively, "some take social entrepreneurship to be essentially the same phenomenon as capitalist entrepreneurship, except with a social, as opposed to a profit-based, motive."[60] The underlying idea is that for-profit forms are pragmatic, efficient, and successful, and to have the same successes, nonprofits must mimick their behavior:

> Old-style charity is out. Performance metrics, business jargon, "venture philanthropy," collaboration with for-profit partners, and cost savings are in. In this climate of skepticism about the efficacy and efficiency of traditional charity, those who want to promote a robust vision of the nonprofit sector have an added incentive to appropriate the entrepreneurial label.[61]

A. *Efficiency and Compensation*

Knowing whether nonprofits are less efficient than for-profits requires evaluating comparable nonprofits and for-profits—those that, among other things, have the same goals and produce the same goods. Finding comparable institutions is a notoriously difficult exercise.

Instead of relying on empirical evidence, therefore, Malani and Posner theorize that for-profits are more efficient than nonprofits because of intrinsic differences in their compensation schemes. Owners and executives of for-profit firms generally receive performance-based compensation, which both motivates high levels of attention and effort and attracts managers who are confident in their capabilities.[62] These benefits of performance-tailored compensation are presumably lost if managers are paid like bureaucrats, which is generally not true of the corporate sector of U.S. businesses,[63] but may be characteristic of nonprofits.

There is an important distinction here between what is and what must be. Malani and Posner appear to presume that nonprofits may only pay their managers fixed salaries,[64] this presumption doubtless stemming from the

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59. David E. Pozen, *We Are All Entrepreneurs Now*, 43 WAKE FOREST L. REV. 283, 296 (2008).

60. *Id.*

61. *Id.* at 321.

62. Pallotta's claims are similar, although he tends to focus on the sheer size of for-profit compensation. *See* PALLOTTA, *supra* note 51, at 62–63 tbls. 2–3 (comparing the salaries of the highest paid for-profit health insurance executives and health charity executives). As Pallotta acknowledges, he excludes highly paid hospital CEOs.

63. *See, e.g.*, Hall & Liebman, *supra* note 57, at 653.

64. *See, e.g.*, Malani & Posner, *supra* note 12, at 2043 ("If an entrepreneur forms a nonprofit firm, she will receive only a fixed income. If her cost structure is such that she can make profits (revenues minus costs, including her salary) even at the competitive price for her output, she will not be able to take that profit home as income."). It is a common misunderstanding that for-profits may set executive salaries according to value and nonprofits may not. PALLOTTA, *supra* note 51, at 36–37.

requirement that a nonprofit is exempt under § 501(c)(3) only if "no part of the net earnings . . . inures to the benefit of any private shareholder or individual."[65] This requirement does not, however, mean that salaries must be fixed. The IRS recognizes that, "when there are adequate safeguards, benefits derived from incentive compensation plans accrue not only to the affected employee, but also to the charitable employer through increased productivity or cost stability, thus adding to, rather than detracting from, the accomplishment of their exempt purpose."[66] Nonprofits, therefore, may structure executive compensation so that it varies with quantity or quality of output, including verifiables such as safe water to poor countries. These are the very things that donors do and charities ought to care about.

The IRS may even permit nonprofit employers to structure a salary based on *net earnings* if it is done without conferring an excess benefit or a private benefit on a shareholder or other individual, although the extent to which this is possible remains uncertain; after withdrawing proposed standards for when a revenue-sharing transaction would amount to an excess benefit in 2001, Treasury has yet to develop final regulations.[67] However, a 1987 exempt organizations continuing professional education text noted:

> This is not to imply that a salary based on net earnings is *per se* improper . . . . Prohibited inurement would result from such an arrangement only when all the facts and circumstances surrounding the relationship indicate a conferral of private benefit without a corresponding achievement of an exempt purpose. The compensation arrangement can reflect a low potential for substantial conflicts of interest if the plan is adequately limited and safeguarded against abuse.[68]

Nonprofits do not have carte blanche in compensating their executives. But neither do for-profits. The law requires nonprofits to set executive compensation at a reasonable level, a standard set by compensation markets that may include for-profit firms. Similar restrictions forbid for-profits from de-

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65. I.R.C. § 501(c)(3) (2006).

66. *Health Care Update*, *in* EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION TECHNICAL INSTRUCTION PROGRAM FOR THE FISCAL YEAR 1987, pt. 3(A) (1987). According to the ABA Coordinating Committee on Nonprofit Governance, "Executives (and directors if appropriate) should be compensated fairly and in a manner that reflects their contribution to the organization. Such compensation . . . *may include incentives that correspond to success or failure in meeting performance goals*." ABA COORDINATING COMMITTEE ON NONPROFIT GOVERNANCE, GUIDE TO NONPROFIT GOVERNANCE IN THE WAKE OF SARBANES-OXLEY 18 (2005) (emphasis added).

67. FREMONT-SMITH, *supra* note 15, at 257–58; Treas. Reg. § 53.4958-5 (2008) (still noted as reserved as of July 2008).

68. *Health Care Update*, *supra* note 66, pt. 3(A). In the health care context, after a period of relative permissiveness regarding revenue-sharing joint ventures between physicians and hospitals, the IRS has tightened its restrictions on joint ventures and now seems to require limits on private gains that would be paid by the nonprofit entity. *See* Consuelo Lauda Kertz, *Executive Compensation in Tax-Exempt Organizations: Reasonableness, Comparability, and Disclosure*, 71 TULANE L. REV. 819 (1997).

ducting salary or other compensation that is "unreasonable."[69] Therefore, the hypothetical entrepreneur that motivates Malani and Posner's article may very well find that operating her clean-water operation as a for-profit won't help her achieve her goal of "maintaining a comfortable lifestyle" any better than would operating a nonprofit charity.[70]

Interestingly, nonprofits face the same constraints since excess benefit regulations[71] refer back to sections of the code governing reasonableness in for-profit compensation.[72] The code requires reasonable compensation, or the amount that would ordinarily be paid for like services by like enterprises, whether taxable or tax exempt, under like circumstances. Although it is not forbidden to do so, if a nonprofit only uses for-profit comparables in determining executive compensation, it is more likely to capture the attention of the IRS.[73]

In addition to reasonableness limitations on nonprofit executive pay, there are two other important restrictions on nonprofit compensation. The compensation scheme must not violate (1) private inurement restrictions under I.R.C. § 501(c)(3), and (2) private benefit rules under Treasury regulations.[74] But by carefully designing incentives, nonprofits may still achieve the hypothetical entrepreneur's second goal in choosing a for-profit form: compensating employees with payments akin to equity-based or

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69. I.R.C. § 162(a)(1) allows for-profit entities a tax deduction for a "reasonable allowance for salaries or other compensation for personal services actually rendered." I.R.C. § 162(a)(1) (2006). Regulations state that the "test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services." Treas. Reg. § 1.162-7(a) (2008).

70. Making more money is one of the hypothetical entrepreneur's motivations for wanting to form a for-profit charity. Malani & Posner, *supra* note 12, at 2019.

71. Nonprofits are subject to I.R.C. § 4958, which defines "excess benefit transaction" as "any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit." I.R.C. § 4958(c)(1)(A) (2006).

72. Treas. Reg. § 53.4958-4 (2008).

73. For more detail, see Jill S. Manny, *Nonprofit Payments to Insiders and Outsiders: Is the Sky the Limit?* 76 FORDHAM L. REV. 735, 737, 741–44 (2007). There has been some uncertainty over the past several years regarding whether pay that is reasonable under I.R.C. § 4958, and therefore does not constitute an excess benefit transaction, might nonetheless violate I.R.C. § 501(c)(3). This issue was raised in discussing the risks of revenue sharing arrangements in a recent IRS Exempt Organization division phone forum in which a representative of the division noted that "while 4958 might not apply to a revenue sharing arrangement with non disqualified persons, you still may have a private benefit issue, depending on how many employees are involved and how extensive the sharing." Internal Revenue Service, Executive Compensation Phone Forum 12, May 17–18, 2006, http:// www.irs.gov/pub/irs-tege/may_17_final_script_exec_comp_phone_forum.pdf.

74. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (as amended in 2008). The private inurement rules prohibit any degree of private ownership of nonprofits and are typically thought to embody the nonprofit nondistribution constraint. The private benefit restrictions protect the charitable purposes of a nonprofit by prohibiting anything but an incidental benefit to accrue to private parties. See Manny, *supra* note 73, at 744–47, for an excellent review of the rules and their differences. For even more detail, see Harvey P. Dale, The Crux of Charity: Inurement, Private Benefit, and Excess Benefit Transactions (Oct. 28, 2004) (unpublished manuscript), *available at* http://www1.law.nyu.edu/ncpl/library/publications/Conf2004_Dale_DRAFT.pdf.

revenue-based compensation.[75] However, as Malani and Posner recognize, profit-sharing may be limited to workers who do not exercise control over the nonprofit.[76] Still, none of this means that the law forbids nonprofits from offering executives and other employees incentives to achieve nonprofit goals.

Despite being permitted to do so, nonprofits may in practice be less likely than for-profits to use incentive pay.[77] But reliable comparisons of nonprofit and for-profit behavior, including the use of incentive pay, are hard to come by since there are few industries in which comparable nonprofits and for-profits compete.[78] It is even difficult to find absolute estimates of incentive pay to nonprofit employees. Some older research shows that nonprofit hospital administrators were more likely to use set raises rather than performance-based raises in 1956,[79] but more recent studies on whether nonprofit managerial pay is linked to performance are indeterminate.[80] Anecdotal evidence suggests that nonprofits are increasingly interested in linking pay to performance, but some fear that doing so risks their tax exemption.[81] Nonprofit-management texts address various forms of incentive pay such as merit pay, but warn that incentive pay systems must be designed carefully.[82] Text authors warn, for example, that

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75. Malani & Posner, *supra* note 12, at 2019 ("Or perhaps the entrepreneur and donors believe that she cannot motivate her employees to work hard unless he can offer them a share of the firm's profits."). In discussing the factors used to determine whether an executive's compensation is reasonable, the IRS notes:

> A third element listed in the G.C.M. [General Counsel Memorandum 38905, June 11, 1982] requires that the amount of compensation not be dependent principally upon incoming revenue of the exempt organization, but rather upon the accomplishment of the objective of the compensatory contract. In the context of "reasonable magnitude of compensation," this factor emphasizes that the salary level should be based mainly on how effectively and efficiently the executive performs his duties and runs the hospital operations in order to further the hospital's charitable and educational purposes.

Health Care Update, *supra* note 66, pt. 3(A). According to Treasury regulations, "[t]he fact that a compensation arrangement is subject to a cap is a relevant factor in determining the reasonableness of compensation," thus possibly placing a practical limit on the extent of incentive compensation. Treas. Reg. § 53.4958-4(b)(1)(ii) (as amended in 2002).

76. Malani & Posner, *supra* note 12, at 2065 n.66.

77. This may be, in part, because of public perception. *See* PALLOTTA, *supra* note 51.

78. For a thorough summary of empirical research in nonprofit compensation, see Kevin F. Hallock, *Compensation in Nonprofit Organizations*, (Cornell Univ. Faculty Publ'ns—Human Res. Studies, 2000), *available at* http://digitalcommons.ilr.cornell.edu/cgi/viewcontent.cgi?article=1017&context=hrpubs.

79. Kenneth W. Clarkson, *Some Implications of Property Rights in Hospital Management*, 15 J.L. & ECON. 363 (1972).

80. Kevin F. Hallock, *Managerial Pay and Governance in American Nonprofits*, 41 INDUS. REL. 377 (2002).

81. *Id.*

82. *See* JOAN E. PYNES, HUMAN RESOURCES MANAGEMENT FOR PUBLIC AND NONPROFIT ORGANIZATIONS, 243–49 (2d ed. 2004); *see also* ROBERT L. HENEMAN, MERIT PAY: LINKING PAY INCREASES TO PERFORMANCE RATINGS (1992); EDWARD E. LAWLER III, REWARDING EXCELLENCE: PAY STRATEGIES FOR THE NEW ECONOMY 159–64 (2000); James L. Perry, *Compensation, Merit*

employees may game the compensation system by setting artificially low goals when their pay is based on achievement.[83]

Even if there were reliable evidence that for-profits are more likely than nonprofits to use incentive pay to motivate employees, it would not follow that nonprofits or their managers were less efficient.[84] Compensation schemes vary, even within sectors, because needs differ. Although nonprofit managers are certainly motivated by money, they may have intrinsic motivation that generally requires fewer financial incentives for high performance than do their for-profit counterparts. Nonprofit employees may be more loyal to their employers than for-profit employees if, as is often alleged, nonprofits provide more "pleasant amenities on their job, such as flexible hours, more stable job prospects, . . . a slower pace of work" or control over their working environments.[85] Moreover, the use of performance-based schemes in the nonprofit sector could have adverse consequences both because the relevant performance is so difficult to measure and because the characteristics of those who choose managerial positions with performance-based pay are not those that are best suited to pursue nonprofit missions.

The limited available evidence shows that nonprofit and for-profit employees have different observable characteristics. Nonprofit employees, for example, tend to be older and more educated, and are much more likely to be female than for-profit employees.[86] Differences in employee demographics indicate that nonprofit and for-profit employees might respond differently to incentives, or that the most effective incentives differ in the two sectors. The strongest evidence on this point is that, despite their ability to tie compensation to performance, there is not much evidence that nonprofits do so. Presumably this is because either performance-based compensation would have undesirable effects, or else that a failure of competition in the nonprofit market means that inefficient practices have not been eradicated.

It is tempting to conjecture that for-profits have an advantage over nonprofits due to the relative ease of measuring performance. After all, profits have the virtue of being easily counted, and if an organization's goal is to make profits, then it is hard to think of a better measure. But in the case a

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Pay, and Motivation, *in* PUBLIC PERSONNEL ADMINISTRATION: PROBLEMS AND PROSPECTS 143 (Steven W. Hays & Richard C. Kearney eds., 4th ed. 2002).

83. PYNES, *supra* note 82, at 244 (citing WAYNE F. CASCIO, APPLIED PSYCHOLOGY IN PERSONNEL MANAGEMENT (4th ed. 1991); Edward E. Lawler III, *Pay for Performance: A Strategic Analysis*, *in* 3 COMPENSATION AND BENEFITS 3-136 (Luis R. Gomez-Mejia ed. 1989)).

84. Malani and Posner suggest that if an owner cannot take shares in a charity, she will either (1) not open the charity, or (2) will open a charity that "will not be as productive or efficient" as the hypothetical for-profit charity would have been. Malani & Posner, *supra* note 12, at 2019.

85. Hallock, *supra* note 80, at 382–83. It may also be the case that nonprofit employees pay for those amenities in forgone wages rather than dedication. Of course the tax system effectively subsidizes (by not taxing) nonpecuniary employee compensation that takes such forms, though this subsidy is available to for-profit firms as well as nonprofits. *Cf.* Alvin Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 YALE L.J. 1081, 1096 (1980) (discussing the inappropriateness of taxing benefits to the psyche).

86. Hallock, *supra* note 78, at 38.

nonprofit organization, whose goal is the provision of public goods, a profit measure is unlikely to capture good performance. This leaves the analyst in the difficult position of comparing the outputs of organizations with different objectives; but just because one cannot easily measure nonprofit output does not mean that it is insufficient.

The difficulty of measuring nonprofit output creates problems beyond the risk that observers might underestimate the value of nonprofit production. By the same reasoning, the manager of a hybrid organization who successfully earns profits on the for-profit side may or may not be successful in providing public goods on the nonprofit side, making it difficult to know how to incentivize and reward such managers. And even in the strictly for-profit sector, recent events call attention to the fact that for-profit corporate compensation systems do not always successfully incentivize managers to maximize long-run profits. As anecdotal evidence that for-profits disproportionately attract top talent through huge compensation packages, Dan Pallotta lists the total compensation of five corporate leaders.[87] These include the former C.E.O. of KB Home, Bruce Karat, who voluntarily retired after backdating stock options and has since been indicted,[88] and the former C.E.O. of Lehman Brothers, R.S. Fuld, Jr., who oversaw the decline of the storied bank into bankruptcy.[89]

Finally, it remains true that, in those circumstances in which for-profits are in fact more productive than their nonprofit counterparts, nonprofit organizations can harness the skills of for-profits by hiring them on a contract basis. Examples are plentiful: nonprofit hospitals often hire for-profit management companies; and nonprofit schools, particularly charter schools, work with for-profit service providers.[90] In more extreme versions of such contracting, nonprofits can and do establish for-profit subsidiaries that are taxable but nonetheless may create beneficial opportunities to exploit aspects of for-profit organization.[91] The virtue of arms-length contracting with

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87. PALLOTTA, *supra* note 51, at 70.

88. William Heisel, *KB Home ex-CEO Bruce Karatz accused of stock option fraud*, L.A. TIMES, Mar. 6, 2009, http://articles.latimes.com/2009/mar/06/business/fi-karatz6; *Former KB Home CEO's severance pay eyed*, MSNBC, Jan. 10, 2007, http://www.msnbc.msn.com/id/15813494; *Judge: Evidence Allowed in ex-KB Home Chief Trial*, N.Y. TIMES, Nov. 9, 2009, http://www.nytimes.com/aponline/2009/11/09/business/AP-US-KB-Home-Backdating.html?_r=2&scp=1&sq=%22kb%20home%22&st=cse.

89. *An Epidemic of Capital Destruction*, N.Y. TIMES, Sept. 12, 2009, http://www.nytimes.com/2009/09/13/weekinreview/13word.html?_r=1&scp=23&sq=Richard+S.+fuld&st=nyt; *Analysts blame CEO's overconfidence for Lehman's bankruptcy*, SILICONINDIA, Sept. 17, 2008, http://www.siliconindia.com/shownews/Analysts_blame_CEOs_overconfidence_for__Lehmans_bankruptcy-nid-46694.html (blaming Fuld personally for the collapse of Lehman); Andrew Clark, *You might think Lehman boss Fuld would be chastened*, GUARDIAN, Oct. 8, 2008, http://www.guardian.co.uk/business/2008/oct/08/lehmanbrothers.banking1 (reporting Fuld's unapologetic testimony before Congress); *One year later, Lehman alumni move on*, SIFY, Sept. 14, 2009, http://sify.com/finance/one-year-later-lehman-alumni-move-on-news-international-jjokEleeijg.html.

90. John Morley, *For-Profit And Nonprofit Charter Schools: An Agency Costs Approach*, 115 YALE L.J. 1782, 1789–93 (2006).

91. *See, e.g.*, Howard P. Tuckman, *The Strategic and Economic Value of Hybrid Nonprofit Structures*, *in* NONPROFITS & BUSINESS, *supra* note 13, at 129.

for-profit providers is that it maintains a separation between the pursuit of charitable mission and the retention of profits, thereby avoiding some of the incentive problems created by combining the two organizational goals.

B. *Bringing Competition into the Picture*

Arguments for the superior efficiency of for-profits are commonly based on the inaccurate notion that for-profits face robust competition, while nonprofits do not compete at all. Neither caricature is true. Many for-profits face little competition, and nonprofits do not operate in isolation. In evaluating the efficiency of each type, one needs to know how nonprofits and for-profits behave in comparable markets, and how nonprofits and for-profits react when operating in the same market (or are facing the threat of interaction). Knowing this is critical for disaggregating the effects of ownership and competition, but there are few reliable data. Moreover, viewing nonprofits as competitors sheds a different light on the nonprofit form.

How competitive is the nonprofit sector? In 2006, there were over 1.9 million nonprofit organizations in the United States.[92] These numbers alone suggest a degree of competition that makes it unlikely that nonprofit organizations could overlook or fail to be influenced by intense competition. It is an understatement to say that the last 500 years of Western civilization have been shaped by competition among religious organizations, a process that continues to this day, and is equally, though more subtly, replayed in markets for nonprofit activities. The virtue of markets is that they provide a forum for competition, and as Adam Smith and every subsequent thoughtful observer has noted, it is the competition, rather than the profits, that generates the benefits we associate with markets.[93]

Although we cannot offer quantitative measures of nonprofit competition, it is worth canvassing the many ways in which nonprofits compete. Nonprofits compete with the other (almost two million) nonprofits, as well as with for-profit and government firms. First, they compete on the demand side. Just like for-profits, they need inputs such as employees, land, and capital to function. In some cases, as in labor markets for lower-level staff, they will be quite similarly situated to for-profits. In fact, the overall wage differential between nonprofits and for-profits is zero.[94] It seems implausible, for example, that there are many specialty nonprofit or for-profit carpenters.

But there are systematic differences between ownership types regarding some input costs, such as the cost of land. Because of their property tax exemptions, nonprofits may have a competitive advantage over for-profits in

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92. INDEP. SECTOR, FACTS AND FIGURES ABOUT CHARITRABLE ORGANIZATIONS (2009), http://www.independentsector.org/programs/research/Charitable_Fact_Sheet.pdf (last visited Oct. 19, 2009).

93. 1 ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 73–81 (R. H. Campbell et al. eds., Oxford Univ. Press 1976) (1776).

94. Eleanor Brown & Al Slivinski, *Nonprofit Organizations and the Market*, *in* THE NONPROFIT SECTOR, *supra* note 4, at 140, 142.

buying land. To know whether this is true, of course, depends on identifying the underlying value of the land for different uses. But even if nonprofits are favored over for-profits in the acquisition of land, this does not mean that nonprofits fail to compete. Nonprofits with property tax exemptions will compete with each other for that input, and they will frequently do so on equal footing.[95]

It is similarly difficult to generalize about competition for capital. For-profits and nonprofits often compete for the same user fees, particularly in the healthcare industry. They might directly compete for grants and government contracts, and those markets may or may not be competitive. In fact, nonprofits and for-profit hospitals both make substantial use of debt, and some have proposed that, relative to for-profits, nonprofits face tighter constraints on capital because of limits on access to debt markets.[96]

The market for donations, which account for only one-fifth of the sector's revenues, is largely, although surprisingly not entirely, limited to nonprofit competitors.[97] Even some for-profits benefit from donations, both in the form of money and volunteer labor. For example, for-profit, privately owned daycares have scholarship funds and parent-teacher associations that are funded, at least in part, with private donations. They also have work days in which parents and other community members volunteer their labor to spruce up classrooms and fix climbing structures. For-profit hospitals manage active volunteer programs.[98]

The research on fundraising typically models the relationship between donors and nonprofits, but it does not identify the level of competition in markets for donations.[99] So how do we know that nonprofits compete for donations? Susan Rose-Ackerman's work,[100] in which she models fundraising as a highly competitive analogue to advertising, notes that there are purely informational purposes for advertising—consumers need to find your product and your firm—but this explanation may carry few implications for nonprofits. Unless fundraising is terribly inefficient, the large volume of

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95. Some nonprofits make payments in lieu of taxes rather than paying local property taxes, though these voluntary payments are small compared to the property tax liabilities of firms without tax exemptions.

96. Frank & Salkever, *supra* note 6, at 133; Timothy J. Goodspeed & Daphne A. Kenyon, *The Nonprofit Sector's Capital Constraint: Does It Provide a Rationale for the Tax Exemption Granted to Nonprofit Firms?*, 21 PUB. FIN. Q. 415 (1993).

97. INDEP. SECTOR & URBAN INST., THE NEW NONPROFIT ALMANAC & DESK REFERENCE 54–56 (Murray S. Weitzman et al. eds., 2002).

98. *See, e.g.*, Alleghany Regional Hospital, Volunteer Opportunities, http://www.alleghanyregional.com/CustomPage.asp?guidCustomContentID=C5A2C1E8-584D-4DB6-B1A7-203ACF38EE51 (last visited Oct. 19, 2009) (for-profit hospital seeking volunteers).

99. James Andreoni, *Toward a Theory of Charitable Fund-Raising*, 106 J. POL. ECON. 1186 (1998); Brown & Slivinski, *supra* note 94, at 143–46; John J. Havens et al., *Charitable Giving: How Much, by Whom, to What, and How?*, *in* THE NONPROFIT SECTOR, *supra* note 4, at 542.

100. *E.g.*, THE ECONOMICS OF NONPROFIT INSTITUTIONS: STUDIES IN STRUCTURE AND POLICY (Susan Rose-Ackerman ed., 1986); Susan Rose-Ackerman, *Charitable Giving and "Excessive" Fundraising*, 97 Q.J. ECON. 193, 194 (1982).

appeals from a single organization to the same donor suggests that they are not simply educational.[101] Further, nonprofits need not produce the same good to engage in rigorous competition for donations. Eleanor Brown and Al Slivinski explain that the Rose-Ackerman fundraising model "recalls the standard economic notion of monopolistic competition: there are many nonprofit establishments competing for donations via fundraising, each of them producing a distinct mix of services determined by the preferences of the nonprofit's owner-manager, in a market with no barriers to entry."[102] Independent charity-rating agencies do not restrict their ratings to single types of charitable causes, but rate charities across industries so that donors may choose among them.[103]

That stereotype brings to mind an image of the impecuniousness nonprofit organization compared to its for-profit cousins hardly implies that the level of competition is less intense; if anything, the reverse should be expected. Threadbare organizations tend to be the most intense competitors, since their existences hang in the balance, whereas wealthy organizations have the ability, and the observed proclivity, not to compete as intensely.[104]

Nonprofits also compete quite aggressively to supply goods and services. As Brown and Slivinski explain:

> The provision of services puts nonprofits squarely in the role of market participants. Even when their missions can be pursued without recourse to market transactions (serving a clientele who do not pay for services, for example), nonprofits must make decisions about quality, quantity, and prices charged for ancillary services. They have choices to make about the provision of mission-related services to mission-extraneous clients (as by a health clinic designed to serve the poor but open to all) and of other services that can generate net revenue to subsidize mission-fulfilling activities.[105]

Moreover, empirical evidence supports the notion that nonprofits compete, often directly, with other types of firms. There are nonprofit, government, and for-profit hospitals in the same town. The daycare market is split among all three forms as well (60 percent nonprofit and government, including a small number of publicly run centers, and 40 percent for-profit).[106] In fact, the authors' children have attended all three types. What

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101. Appeals that succeed in eliciting contributions from other donors may convey information, however. *See* Lise Vesterlund, *The informational value of sequential fundraising*, 87 J. PUB. ECON. 627 (2003).

102. Brown & Slivinski, *supra* note 94, at 143.

103. *See, e.g.*, Better Business Bureau, http://www.bbb.org/us/charity (last visited Oct. 19, 2009); Charity Navigator, http://charitynavigator.org (last visited Oct. 19, 2009).

104. Economics Nobel laureate J.R. Hicks notably observed that "[t]he best of all monopoly profits is a quiet life." J.R. Hicks, *Annual Survey of Economic Theory: The Theory of Monopoly*, 3 ECONOMETRICA 1, 8 (1935).

105. Brown & Slivinski, *supra* note 94, at 146.

106. John R. Morris & Suzanne W. Helburn, *Child Care Center Quality Differences: The Role of Profit Status, Client Preferences, and Trust*, 29 NONPROFIT & VOLUNTARY SECTOR Q. 377, 377 (2000).

about entertainment? Theater companies are a mix of forms, and audiences choose between watching a for-profit band or a nonprofit symphony on a given night.

Since there are almost two million nonprofits, one would expect tremendous competition within the sector, even without competition from other types. But how competitive are these markets? Markets vary in terms of competitiveness and other characteristics, and this makes it difficult to draw general conclusions about the relative efficiency of various ownership types without more detail regarding how they compete. Although there is little research attempting to disaggregate nonprofit ownership and market effects, there is a large body of relevant research comparing public and private production. For example, Douglas Caves and Laurits Christensen's research addressed the common but unsubstantiated assertion that private ownership leads to more efficient production than public ownership.[107] They noted that the claims did not account for efficiency differences based on market structure. Comparing two very large Canadian railroads operating in a competitive environment—one private and one public—they found "no evidence of inferior efficiency performance by the government-owned railroad" and, in fact, some evidence that the public railroad had achieved higher productivity gains.[108] This research holds some important lessons for nonprofit scholarship.

Finally, even if giving for-profits the incentive to enter traditionally nonprofit markets would make those markets more competitive, doing so might decrease social welfare. The largest nonreligious, nonprofit markets include many for-profit entities such as nursing homes, hospitals, and schools. Empirical studies of nursing homes suggest that the existence of more nonprofits in a market is associated with higher output quality.[109] If quality is underprovided by competitive markets, then there will be circumstances in which encouraging for-profit entry by giving them incentives to produce greater numbers of charitable goods would depress quality and undermine a policy goal that motivates the nonprofit tax subsidy.[110]

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107. Douglas W. Caves & Laurits R. Christensen, *The Relative Efficiency of Public and Private Firms in a Competitive Environment: The Case of Canadian Railroads*, 88 J. POL. ECON. 958, 959–60 (1980).

108. *Id.* at 960–61.

109. Richard A. Hirth, *Consumer information and competition Between nonprofit and for-profit nursing homes*, 18 J. HEALTH ECON. 219, 234–36 (1999) [hereinafter Hirth, *Consumer Information*]; *cf.* Richard A. Hirth, *Competition Between For-profit and Nonprofit Health Care Providers: Can it Help Achieve Social Goals?*, 54 MED. CARE RES. & REV. 414, 425–26 (1997) [hereinafter Hirth, *Competition*].

110. This is analogous to the analysis of Kotchen, who considers a model in which the introduction of "green goods" provided by for-profit firms may either increase or reduce total contributions to the environment (here counting the "green" component of green goods as contributions to the environment), since green purchases from for-profit firms typically crowd out more direct contributions to nonprofit environmental causes. Kotchen, *supra* note 54, at 828–31.

Similarly, although many studies find little difference between for-profit and nonprofit hospitals in quality or efficiency of production,[111] these studies often overlook ways in which nonprofits might offer superior services. For example, for-profit hospitals show a dramatic increase in the likelihood of offering medical services when they are profitable that disappears when they are unprofitable. It is hard to imagine that the reimbursement system accurately prices these services to reflect quality concerns. Rather, the findings suggest that for-profits chase profits at the expense of quality.[112]

For-profit ownership also has spillover effects, and to the extent for-profit behavior is undesirable, increasing for-profit market share is undesirable. In markets with both nonprofit and for-profit firms—e.g., markets where producer and consumer roles are typically somewhat mixed and prices are largely unobserved—characterizing how firms interact under oligopoly or other competitive settings is difficult at best. Nevertheless, it is reasonable to expect that an increased share of for-profit providers in a market may influence the equilibrium behavior of both for-profits and nonprofits in various ways. For example, if for-profit hospitals successfully attract the most profitable patients (perhaps by forgoing services that are disproportionately attractive to poor patients, by offering greater hotel services and other amenities, or by aggressively billing and rebilling less profitable patients), it is plausible that their behavior puts price pressure on nonprofits in the same markets. Nonprofits might then have to restrict output or else position themselves to attract more profitable patients and procedures. Horwitz and Nichols offer evidence of the latter behavior, as a rising share of for-profit hospitals in a market is associated with behavior on the part of nonprofit hospitals that more closely resembles that of their for-profit competitors.[113]

IV. TAKING NONPROFIT CHARITIES SERIOUSLY

As discussed above, Malani and Posner frame their endorsement of for-profit charities through a critique of five arguments commonly made to justify public support of the nonprofit form. We review in detail the four most significant of these arguments: (A) public goods, (B) agency, (C) altruism, and (D) imperfect consumers.[114]

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111. For a useful review, see Frank A. Sloan, *Not-for-Profit Ownership and Hospital Behavior*, *in* 1B HANDBOOK OF HEALTH ECONOMICS 1141 (Anthony J. Culyer & Joseph P. Newhouse eds., 2000); *cf.* Mark Schlesinger & Bradford H. Gray, *How Nonprofits Matter In American Medicine, And What To Do About It*, 25 HEALTH AFF. w287 (2006).

112. Jill R. Horwitz, *Does Nonprofit Ownership Matter?*, 24 YALE J. ON REG. 139 (2007); Jill R. Horwitz, *Making Profits and Providing Care: Comparing Nonprofit, For-Profit, And Government Hospitals*, 24 HEALTH AFF. 790 (2005) (demonstrating that for-profit hospitals are significantly more responsive to financial incentives to offer or avoid medical services than are comparable nonprofit hospitals).

113. Jill R. Horwitz & Austin Nichols, *Hospital Ownership and Medical Services: Market Mix, Spillover Effects, and Nonprofit Objectives*, 28 J. HEALTH ECON. 924–37 (2009).

114. We do not review the fifth argument—that their proposal for for-profit charities does not raise difficult problems for administration—because it is the least significant of the arguments and

Naturally there are other justifications for tying nonprofit status to benefits. These include Boris Bittker and George Rahdert's income-defining theory, which Malani and Posner dismiss in a footnote as unproblematic for their theory, as well as noneconomic theories based on sovereignty and moral obligations that the authors disregard.[115] Even within the economic paradigm that Malani and Posner embrace, however, their argument warrants reconsideration.

A. *Public Goods and Positive Externalities*

The argument for for-profit charities begins with a critique of what Malani and Posner term the "public goods theory." If a firm produces a good or service with public-good attributes, meaning a positive externality, then for-profits, or anyone else motivated solely by private interest, will produce too little of the good. This is because consumers consider their own marginal *private* benefits rather than the greater marginal *social* benefits when deciding how much they are willing to pay for the good. A common example of a good with a positive externality is education. Better-educated people make better citizens, improve the quality of democratic decision making, are less likely to lead lives of crime, and otherwise contribute positively to the lives of others. When a student decides to purchase education, she typically considers only how much she or her family might benefit from her knowledge, rather than how much the rest of society might benefit, so she has an incentive to purchase too little education.

There are many potential solutions to this problem. The state could subsidize producers (e.g., with grants to universities) or consumers (e.g., with low-interest government loans to students) by the amount of the excess of marginal social benefit over marginal private benefit.[116] Alternatively, the government could regulate output or prices. Or it might simply produce the good directly, a solution that Malani and Posner reject because of the difficulty government faces in determining and aggregating preferences. They endorse subsidies as being less cumbersome than the other solutions, and further argue that if government support of charities is premised on the public-good nature of what charities do, then there is no reason to subsidize only nonprofits, but also for-profits producing the same goods.[117]

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others have ably discussed the difficulties the IRS would face in distinguishing between charitable and non-charitable for-profits. Professor Victor Fleischer raises concerns about administration of a new system in Victor Fleischer, Response, *"For Profit Charity": Not Quite Ready for Prime Time*, 93 VA. L. REV. IN BRIEF 231 (2008), http://www.virginialawreview.org/inbrief/2008/01/21/fleischer.pdf.

115. Malani & Posner, *supra* note 12, at 2029 n.25. For other theories regarding justifications for nonprofit exemptions, see, for example, Evelyn Brody, *Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption*, 23 J. CORP. L. 585 (1998); Horwitz, *supra* note 15, at 1380–86.

116. The efficient subsidy rate is determined by marginal benefits at the socially optimal production or consumption level. The scheme of optimal corrective government subsidies was first proposed by A. C. PIGOU, THE ECONOMICS OF WELFARE 699–704 (4th ed. 1932).

117. Malani & Posner, *supra* note 12, at 2064–67; *see also* Hyman & Sage, *supra* note 6, at w312 (naming similar arguments in response to the question they pose about nonprofit health pro-

Even assuming the state knows which goods and how much it wants to subsidize, the issue is not as simple as one of encouraging public-good provision in all its forms, since provision by one type of organization influences provision by another.[118] In fact, it is unlikely that a common subsidy rate will induce for-profits to provide the socially optimal output, given their residual profit motive and their disregard of the impact of their actions on competing nonprofits.[119] The efficient subsidy rate needed to encourage entrepreneurs to set up their organizations as for-profits with charitable arms is generally not the same subsidy rate needed to stimulate the efficient level of charitable activity, particularly given spillover effects on the charitable activities of others. One-size-fits-all tax subsidies are seldom efficient, but in this case there is particular reason to expect that subsidies to for-profit firms may exceed efficient levels.

B. *Agency Theory*

A second reason to subsidize nonprofits based on status is that they are best positioned to solve information problems that arise in the provision of charitable goods. Henry Hansmann suggests that consumers or donors cannot directly evaluate the quality or quantity of output. Consider his example of donors who pay $10 to have CARE ship and distribute milk to hungry children abroad.[120] Under circumstances with less geographic distance between donors and beneficiaries, it might still be difficult for donors to verify that their donation went to the intended beneficiaries. Moreover, trust is needed even in circumstances in which there is no external donor. After consuming medical treatment, for example, patients commonly cannot verify that a hospital provided the right treatment.[121] Did the patient recover from his illness because of, in conjunction with, or even despite the medical care?

Malani and Posner counter Hansmann's suggestion by noting that not all purchasers "place value on the noncontractible quality that the nondistribution constraint protects," as for-profits compete successfully in many markets with nonprofits, and, therefore they assume that consumers have ample measures of "verifiable quality."[122] Nonprofit status, therefore, may signal higher quality,[123] and consumers can react accordingly.

The idea that nonprofits and for-profits compete in the same market while occupying similar niches is quite familiar in economic research.

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viders, "does it make any sense to subsidize some health care providers by exempting them from federal, state, and local taxes, based solely on institutional status?").

118. Horwitz & Nichols, *supra* note 113.

119. *Cf.* Malani & Posner, *supra* note 12, at 2048 (discussing altruism, acknowledging that the nonprofit form may well generate superior outcomes).

120. Hansmann, *supra* note 58, at 846 (1980).

121. Kenneth J. Arrow, *Uncertainty and the Welfare Economics of Medical Care*, 53 AM. ECON. REV. 941 (1963).

122. Malani & Posner, *supra* note 12, at 2038–39.

123. *But see* Anup Malani & Guy David, *Does Nonprofit Status Signal Quality?*, 37 J. LEGAL STUD. 551, 573 (2008) (arguing that hospitals do not take nonprofit status to signal quality).

Professor Richard Hirth has developed a model featuring different types of nonprofits, including high or low output, nonprofits managed by either for-profit or nonprofit entrepreneurs, and consumers who can or cannot verify the quality of output.[124] Hirth analyzes a market where some entrepreneurs are for-profit in spirit yet nonetheless adopt the nonprofit organizational form to signal high quality. These entrepreneurs are sneaky: they operate for-profits in disguise, distributing revenues to themselves in the form of higher wages. They shirk on quality to earn higher profits, and are still able to attract uninformed consumers. (This works as long as there are not too many shirkers, so that nonprofits *on average* offer higher quality output than for-profits, and nonprofit status remains a reasonable signal of being a high-quality provider despite the presence of some nonprofits that are really for-profits in disguise.) Hirth therefore concludes that the presence of nonprofits in mixed markets increases overall quality.

Despite the conclusion that nonprofits raise overall market quality, Malani and Posner still worry that it is the favorable tax treatment that allows for-profits in disguise to exist because it gives managers some cushion to shirk and still meet payroll. However, it is difficult to see how this problem would arise if there is sufficient competition among nonprofits, since in a competitive environment inefficient or wasteful producers are driven out of business by more efficient competitors.

At this point, the Malani and Posner article is back on well-traveled terrain. Endorsing contracting for charitable services rather than subsidizing entities based on status, the article asserts that a for-profit firm could equally well contract to distribute no profits to managers or workers, and that "unlike quality, profits are verifiable."[125] If only it were so simple. The problem that donors face in determining whether insiders are receiving inappropriate compensation is difficult enough in the nonprofit context, but worse in the hypothesized case of for-profit charities. Is the football coach's salary or contract buyout a legitimate cost of attracting talent? Imagine throwing profit-sharing into the mix. Donors have legal tools such as reversion interests and gift-overs that permit them to limit their financial commitments to nonprofit donees by creating rights on the part of donors or other charities to receive limited returns of invested capital should subsequent events warrant, thereby protecting them against some of the waste that the critique envisions. Even if the donor does not have standing to sue the nonprofit for such waste, she does have the ability to tip off the attorney general, the local press, or the beneficiary of the gift-over.

Finally, in an important footnote, Malani and Posner claim that a nondistribution constraint is equivalent to a confiscatory tax on profits, but this is

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124. Hirth, *Competition*, *supra* note 109; Hirth, *Consumer Information*, *supra* note 109. Malani and Posner's notion of a nonprofit charity operated by a nonaltruist also is reminiscent of the three models proposed by Mark Pauly and Michael Redisch, albeit with less formal development. *Compare* Malani & Posner, *supra* note 12, at 2034–35, *with* Mark Pauly & Michael Redisch, *The Not-For-Profit Hospital as a Physicians' Cooperative*, 63 AM. ECON. REV. 87, 88–90 (1973).

125. Malani & Posner, *supra* note 12, at 2035.

not quite right.[126] More accurately, a nondistribution constraint is equivalent to a confiscatory tax on *distributions*. Since profits that are earned but not distributed can be used for exempt purposes that are important to nonprofit entrepreneurs, this is an important distinction. A refundable 100 percent tax rate on profits would make profit-motivated for-profit entrepreneurs indifferent across all feasible levels of output, including not operating a firm at all. A nonprofit entrepreneur who maximizes something other than profits cares greatly about the organization's output level and its financial health despite its inability to distribute profits to shareholders.

C. *Altruists*

Malani and Posner next examine whether altruism justifies subsidizing nonprofits based on status. They suggest that if altruists are differentially attracted to employment in nonprofits, then government subsidies to nonprofits (which reinvest profits in charity production) would have a bigger impact on charitable activity than subsidies to for-profits (which transfer profits to entrepreneurs).[127] Malani and Posner begin their critique with the reasonable simplifying assumption that entrepreneurs care *both* about producing some quantity of charitable output and about producing income.

Their critique also assumes that nonprofits produce in a single market to the point at which they make no profits; so, in this market, total cost equals total revenue, or average cost (total cost divided by output quantity) equals average revenue (total revenue divided by output quantity). Producing at the level of output where profits are zero—the point where average cost equals average revenue—is generally not the efficient output level. (Since only in special cases will profits be zero at the efficient level of output, it follows that nonprofits constrained to break even will produce inefficient levels of output.) Rather, efficient output is characterized by the condition that marginal cost—the cost of producing a single additional unit of output—equals marginal benefit—the benefit associated with an additional unit of output. However, the assumption that firms must break even in a single market—the assumption that drives the conclusion that nonprofits produce at inefficient output levels—is unwarranted. The assumption that nonprofits produce at the point that average cost equals average revenue is not, in fact, an implication of the nondistribution constraint under which nonprofits labor. Although nonprofits may not distribute profits to shareholders, they can and do earn profits (and, at times, losses). They may retain their profits or invest them in related charitable purposes or new charitable enterprises.

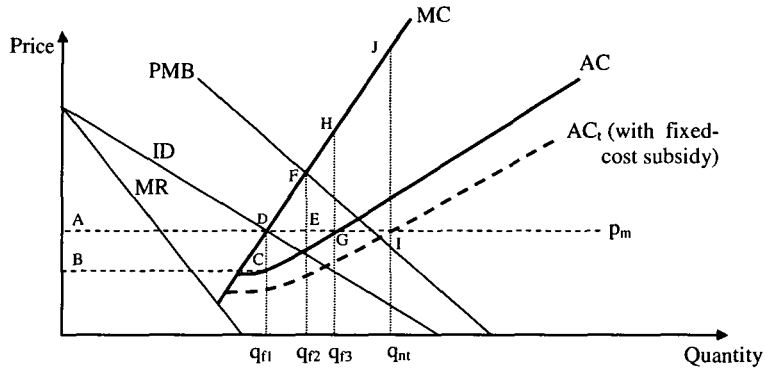
The problem identified by Malani and Posner—that profits are trapped inside nonprofit organizations and therefore must be devoted to subsidizing excessive production of altruistic goods—is one that arises only if organizations have no other uses for their funds. If instead nonprofits with resources to deploy can choose among alternative uses of these resources, then it no

126. *Id.* at 2033 n.31.

127. *Id.* at 2044–55.

longer follows that they are pushed to produce to the point at which social costs exceed social benefits. This possibility is ruled out by a simple one-activity model of the world, but all that this means is that such simple textbook abstractions can produce misleading conclusions if taken too literally.

Here we reproduce Figure 1 from the Malani and Posner article, with additional lines labeled **ID** (inverse demand), **PMB** (private marginal benefit), and **MR** (marginal revenue corresponding to demand **ID**) superimposed on the figure.



Relying on Figure 1, Malani and Posner suggest that, unless a charity produces a public good, a nonprofit will produce too much of the good. This is because the charitable tax exemption allows them to produce at q_{nt}, a quantity beyond which donors value the production of the product. It is correct that the nonprofit has the resources to support this production point. A tax subsidy might lead donors to choose the nonprofit form because the subsidy allows for a big boost in production. And, as Malani and Posner conclude, the cost of production would be greater than the value of the price the donor is willing to pay for production plus the good feelings the donor would generate by producing at q_{nt}. But this observation is beside the point. As explained in more detail below, it focuses on the wrong externality. The government is not trying to ensure that the production decision accounts for donors' good feelings, but rather that the nonprofit subsidy is meant to increase production of goods with particular public benefits.

Malani and Posner further contend that even in the case of public goods, nonprofit production is not necessarily better since it is unclear whether nonprofits or for-profits are, from a social cost perspective, the least-cost suppliers of the good. According to the article, there is no reason to believe that altruistic managers face lower costs than profit-seeking managers, or that there are unconstrained supplies of altruists to run nonprofits. These arguments again rely on unstated assumptions, most notably that the activity depicted in the diagram is the only one available to the nonprofit. If this assumption is incorrect—if, instead, nonprofits can deploy their resources in more than one way and are guided by truly altruistic motives—then the

nonprofit organization will not produce at the q_{nt} point. The nonprofit will produce at the efficient point.

Under our more realistic characterization of the opportunities to spend nonprofit funds, only if there exist no other opportunities for useful spending would a rational altruistic nonprofit choose to produce inefficiently. In extremis one could imagine a nonprofit organization simply contributing any saved resources to a foundation or other nonprofit, or, heaven forbid, the government. But these situations seldom arise, which suggests either that nonprofits behave irrationally or, much more likely, their opportunities for valuable expenditures have not diminished in the way suggested by the rather too simple Figure 1.

There are other causes for concern with their analysis of Figure 1. First, although the article makes a reasonable simplifying assumption that charities face a constant output price p_m, it fails to note the implications of the assumption. The flat line **p**, in Figure 1 implies either (1) perfect competition among suppliers of the good, or (2) perfectly elastic demand among consumers.

What happens when the government subsidizes nonprofits in a perfectly competitive market with free entry by identical competitors? Consider the case of a property tax exemption, which would lower the average cost of nonprofits to $\mathbf{AC}_t$.[128] Profits would be lowered below the level where for-profits could compete, and every for-profit would be driven out of the market without having any effect on the efficiency of production.

If instead there is neither perfect competition nor perfectly elastic demand, then a manager who values only *total market output* produces at the profit-maximizing choice q_{fl} and then uses the profits to purchase additional units of q at the fixed price p_m. A manager who seeks to maximize *output of the firm* subject to the constraint that the firm not lose money would produce at q_{f3} where average cost **AC** equals average revenue p_m (thus rectangular area ABCD, profit of a price-taking profit maximizer, is equal to the area of triangular area DGH). If there is sufficient demand to support output of multiple firms, this is an inefficiently high level of production. None of this analysis requires altruistic managers—only managers who are incentivized to pursue the objectives of the firm, profit-making or otherwise. Why would an entrepreneur or donor contribute capital to an output-maximizing nonprofit? This is where altruism may play a role. An entrepreneur or donor would contribute capital to these firms because they produce goods with positive externalities (i.e., some "community benefit" or "public benefit"), which is explicitly a condition of 501(c)(3) status. This situation is also one in which asymmetric information may play a role—if output is not directly observable, without further knowledge of market interactions, merely knowing that one type of firm always produces weakly higher output at a given price might lead donors to favor that type of firm.

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128. An income tax exemption would have no effect in this case, where income is measured as economic income, since economic income is zero with perfect competition.

Malani and Posner point out that a for-profit could also be induced to maximize output by designing incentives for the manager to maximize output rather than profits. If this were effective, the for-profit would earn zero profits, and pay no taxes, as long as profits for tax purposes were to correspond to economic profits. Thus, of the three major tax advantages a nonprofit enjoys, the first (no corporate income tax) appears irrelevant when comparing output-maximizing firms. Property tax and other exemptions and the deductibility of private donations (from itemizers) may generate resources that increase output by shifting average costs from **AC** to $\mathbf{AC}_t$ and output from q_{fp} to q_{nt}.

There remains the important question of whether a for-profit firm can credibly commit to maximizing output, and therefore not earning profits. In particular, owners of an output-maximizing firm always face an incentive to reduce production a little and earn positive profits, since marginal cost exceeds the market price.[129] Even if firms could make a credible commitment to maximizing output, this would jeopardize the main advantage of the for-profit corporate form—access to equity markets—because a for-profit that credibly commits to earning no profits could not raise capital in equity markets.

Moreover, as mentioned briefly above, Malani and Posner's worry that nonprofits might produce too much ignores the fact that charities produce goods with a "community benefit" or "public benefit," goods that are underprovided in the absence of corrective policy. The article's argument rests on the assumption that the only relevant externality arises from the entrepreneur's "warm glow" from generating higher output. This is not the externality that needs correcting.[130] A manager of a clothing boutique may get a "warm glow" from generating higher output, or seeing more people wearing the store's stylish output, but this is not an externality we seek to correct with the nonprofit form. Similarly, donors of birthday presents may get a "warm glow," but birthday presents are not tax deductible for good reason. This use of "warm glow" as the sole externality, therefore, picks up only a fraction of the relevant externalities.

The nonprofit entrepreneur's "warm glow" may, however, lower her demands for a return on her investments or salary for managing the firm. If the "warm glow" reduces capital or labor costs for the nonprofit, the nonprofit

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129. Any manager whose compensation depends on profitability presumably shares this incentive, though in practice the compensation structures of nonprofits dampen the connection between profits and managerial returns.

130. Malani and Posner come to this conclusion, but only after making the alternative argument described above:

> What if the output being produced is a public good? Then the additional production of quantity by the nonprofit altruist may be efficient. One way to state this is that the tax break modifies an altruistic entrepreneur's costs so that they are more in line with the social value of a good. Another way to state it is that the price that donors pay for additional quantity plus the warm-glow consumption value from the additional quantity do not capture the full public good value of that output. Once that public good value is accounted for, the additional quantity would be worth the costs.

Malani & Posner, *supra* note 12, at 2047.

has a cost advantage over a for-profit, not the other way around. The nonprofit enjoys this cost advantage over a for-profit precisely because donors and workers at the firm know that output is being maximized, rather than the rents being diverted into someone else's pocket.

So at this point it may seem that *nonprofit* charities are better situated than for-profits to receive government subsidies. In fact, Malani and Posner acknowledge that the nonprofit form may well generate superior outcomes if managers of nonprofits produce more output and there are positive externalities associated with production.[131] But this would only be true if nonprofits and for-profits faced the same costs. The article then asserts that nonprofits must have higher costs because they don't have the same incentives to keep costs down as for-profit managers. Further, people willing to be managers of nonprofits are in limited supply while, presumably, the supply of for-profit entrepreneurs is inexhaustible. Unfortunately, the article offers no support for either assertion. Indeed, the first assertion conflicts with the article's assumption that those who opt to work at nonprofit organizations value output.

Finally, the Malani and Posner argument further assumes that firms are price takers. This is another simplifying assumption that distorts the picture of how nonprofits operate. In fact, they tend to produce goods in less than perfectly competitive markets such as hospital care and education. If one makes the reasonable assumption that firms have some market power, they face downward-sloping inverse-demand ("ID") schedules. In such a case, the distinction between a profit-maximizing and output-maximizing firm would be much greater, since marginal revenue and average revenue would not coincide. If we drop the assumption that prices are fixed or that firms believe they are, and instead postulate an inverse demand curve *ID* with downward slope, the efficient output is at q_{f1} in the absence of any externalities. A profit maximizer would choose production where marginal revenue *MR* crosses marginal cost *MC* so that output is inefficiently low, even in the absence of externalities.

An entrepreneur with private marginal benefit *PMB* of additional output still chooses q_{f2} where *PMB* crosses *MC* at point *F*. If the social marginal benefit of additional output exceeds the entrepreneur's private marginal benefit—i.e., there is a positive externality associated with increased output—then this output level is also inefficiently low.

In this setting, an output-maximizing nonprofit manager still chooses q_{f3} in the absence of a subsidy and q_{n1} with a subsidy. These will be inefficient except in the special case that the social marginal benefit crosses *MC* exactly at point *H* in the absence of a subsidy or point *J* in the presence of a subsidy. If the government or donors have further knowledge about the social marginal benefit, they can adjust the subsidy amount to achieve any desired level of output greater than q_{f3} in a way that is not possible to accomplish with a for-profit firm.

131. *Id.*

D. *Imperfect Consumers*

Finally, in considering a more realistic case than the one described in Section IV.B, Malani and Posner ask whether for-profit charities could be justified when prospective donors cannot contract perfectly with charities and, therefore, cannot ensure that their donations go to the intended beneficiaries. They conclude that we should not worry about such luckless donors since consumer protections that apply to usual commercial enterprises could be brought to bear on charities, even for-profit charities. After all, a person who is a victim of fraud by an auto dealer or a grocer is no less vulnerable than a donor to charities who may find that his money has not in fact saved children in Africa.

It is unlikely that consumer protection laws would help with this problem, since the information asymmetry is still unresolved ex post. Shortly after driving home the used car or cutting open the lemons on the kitchen counter the purchaser discovers whether he paid too much or got too little. If a donor cannot go to Africa to count mosquito nets in a village, the asymmetry is never resolved. Contracting for independent audits goes only part way toward helping, just as it does in the usual commercial case. Even the best imaginable auditor cannot detect whether a given level of charitable output was the result of an entrepreneur's effort, spending choices, enemy action, or luck; and, as suggested above, there is simply no way to resolve the information problem in some circumstances, as in the provision of some types of medical care.

Consumer protection is most effective in settings in which violations can be clearly identified, and these are typically cases in which actions rather than motives are at stake. In a for-profit setting the profit motive is understood, and the consumer protection issue is whether in the pursuit of profits the firm violates the rights of consumers. In the case of for-profit charities the mixed motives of the recipient of a donation greatly complicate the task of protecting the interests of donors, since an organization's failure to achieve charitable goals or even to undertake the most effective charitable actions may reflect either excessive profit motivation or just a usual degree of organizational slippage. Since in practice it is extremely difficult to contract ex ante over all of the relevant dimensions of charitable activity, donors are left to rely at least in part on charitable motives, the absence of which is largely unenforceable ex post.

V. Taking For-Profit Charities Seriously: Unintended Tax Consequences

Suppose that the U.S. government decided to run with the logic of for-profit charities and afford them benefits similar to those available to non-profits today. What would be the features of such a regime?

Those who would reform this system have in mind that an individual who gave $1,000 to General Electric ("GE") to promote green energy would be entitled to deduct the $1,000 from his taxable income. Presumably GE

would need to include the $1,000 in its taxable income.[132] Assuming that GE faithfully devotes the $1,000 to a venture that produces no financial return other than that which comes from saving the planet, GE would deduct its $1,000 expenditure on green energy as a cost,[133] and end with zero tax liability and zero net profit. Under the proposed reform, the individual donor would be out $1,000 but receive a tax deduction as partial compensation.

To what extent would such a regime differ from what taxpayers are already entitled to do? If GE announces a costly initiative to help the environment, a taxpayer is certainly entitled to buy shares of GE as a gesture of support. (Equivalently, existing GE shareholders might demand that their company use more of its expertise to help the environment, despite the costs.) If in fact the financial return is low, then the taxpayer will be out perhaps $1,000 relative to what she might have earned by purchasing shares of a company that cares nothing for the environment and everything for profits. Of course, the taxpayer does not lose the whole $1,000. As we noted, the reduced return brings with it a reduced tax liability, and the taxpayer's situation is equivalent to (actually, rather better than) a situation in which she had donated $1,000 directly to the company.[134]

Suppose, for example, that GE has 1 million shareholders and devotes $1 billion of its capital to an environmental project on which it expects to earn no return and lose its entire investment. Any shareholder's pro rata share of this environmental investment is $1,000. GE will ultimately write off this investment, and claim a $1 billion deduction against its taxable income, thereby reducing its corporate tax liability by the product of $1 billion and its tax rate (currently 35 percent). Thus, GE loses $1 billion on the investment but as partial compensation claims a tax loss worth $350 million (35 percent of $1 billion). From the standpoint of an individual GE shareholder, the net cost of the environmental project is $650 ($1,000 minus the pro rata tax benefit of $350), which is the net cost that an individual in a 35 percent tax bracket would incur in making a deductible $1,000 charitable donation.

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132. Contributions are not currently taxable as income to recipients, but permitting individual tax deductions for contributions to for-profit charities would require an accompanying change in which the contributions represented taxable income to the for-profit charities. This taxable income would then be offset by subsequent deductions for expenses or contributions by the for-profit charities. Failure to treat contributions as income while permitting deductions for subsequent charitable expenses would create an irresistible arbitrage opportunity in which any taxable corporation could reduce its income tax liability by persuading (or paying!) donors to route their charitable contributions through the corporation.

133. This assumes that the cost would qualify as an ordinary and necessary business expense under I.R.C. § 162, a condition very likely to be satisfied in practice. *See* I.R.C. § 162 (2006).

134. $1,000 of income that is donated to charity produces the same tax result as no income and no deduction only if the taxpayer can take full advantage of the deduction. As previously noted, fewer than half of all taxpayers itemize their deductions, and among those who do itemize, personal deductions of this sort are limited to no more than half of income and are phased out over a range as income rises. If General Electric undertakes long-term environmental investments that depress share values due to their low financial returns, then shareholders receive full benefits of tax deductibility only if they can take capital loss deductions on their shares at ordinary income tax rates.

Still, there are differences between the current practice and allowing for-profits to access nonprofit tax benefits. One difference relates to specificity: as matters currently stand, all of GE's shareholders benefit (or not) from GE's decision to devote greater resources to green technologies. To the extent that there are tax benefits associated with the resulting lower financial returns, these tax benefits are shared pro rata according to share ownership. A system that permits explicit donations to for-profit corporations would facilitate targeting the benefits to contributors. Note that, if shareholders are in similar tax brackets, aggregate tax benefits are the same either way; though in practice, it would be reasonable to expect that targeting creates opportunities for certain potential donors who would benefit the most from charitable deductions to claim disproportionate shares of these deductions.

Would the potential reform permit unlimited deductions for contributions to for-profit entities, or would the deductions be limited to levels of charitable or worthwhile activity by the recipient, somehow defined? Presumably, the value of deductions should be limited to the marginal excess social value of worthwhile activity inspired by contributions; but that is too much to ask of tax administrators. It does not require very much imagination to envision the nightmare that any such restrictions would produce. Running with the logic of permitting these deductions, however, it is far from clear that any restrictions are needed. Who, after all, would contribute to a for-profit corporation, unless out of the sense of somehow improving the world?

Who indeed? One candidate would be someone who expects to benefit from making such a contribution—and once again, very little imagination is required to envision such cases. A too-obvious example is the case of a father who contributes to a company owned entirely by his daughter. In the absence of restrictions that would surely apply in such an obvious case, the father would take a tax deduction and the daughter's company would include the money as taxable income. There are many cases in which the company's tax rate will fall below the father's tax rate,[135] producing what is, in essence, a net tax deduction for a transfer from a parent to a child. Restricting the tax benefit to altruistic activity on the part of the recipient company does not address the avoidance problem, since it is impossible to distinguish altruistic activity that the company would engage in anyway from altruistic activity for which the gift is responsible.

Quite apart from this obvious tax arbitrage, such a treatment is inconsistent with the income tax system's general treatment of private (i.e., noncharitable) gifts,[136] in which recipients are not taxed, and givers do not receive deductions. There are many nuances to this system, but one of its virtues is that it prevents a large number of the obvious and less obvious tax arbitrages that accompany any other regime. Any deviation from this system

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135. Since tax rates for corporations and individuals rise with income, this condition is generally satisfied if the father has a higher income than the daughter and her company is taxed as a flow-through entity such as a partnership, LLC, S corporation, or proprietorship. If instead the daughter's company is a C corporation, then the condition is satisfied if the father's personal tax rate exceeds the tax rate applicable to the corporation's level of income.

136. *See* I.R.C. § 102 (2006).

creates the potential for enormous tax arbitrage and associated inefficiency, which is why there is so much regulatory and enforcement activity associated with requiring that nonprofit activity not create excessive benefits for certain individuals. The fact that the rest of the tax system distinguishes between private and charitable gifts increases the likelihood that taxpayers would exploit this avenue of making disguised gifts with special tax attributes.

In considering the various tax arbitrages, remember that by far, the bulk of deductible charitable contributions in the United States goes to religious organizations. Imagine a for-profit religious organization seeking donations, with some if not all of the organization's profits retained by the religious entrepreneur in charge. Should all of the contributions be deductible? As matters stand it is extremely difficult for the government to distinguish between deductible contributions to religious organizations and fees for services,[137] and the ability of nonprofit entrepreneurs to retain profits would create irresistible incentives to reclassify fees for profitmaking activities as deductible contributions. And if not—that is, in the politically unrealistic case in which religion is to be taken off the table such that only nonreligious organizations were to qualify for the benefits of this new tax regime—the new regime would compound the difficulties the IRS already faces in distinguishing religious from nonreligious organizations.

Malani and Posner further propose that firms be entitled to appeal to the IRS to permit their donors to receive tax deductions, if necessary paying the administrative costs that the IRS would incur in evaluating the appeal and enforcing subsequent behavior. How exactly this might work is unclear,[138] and given all of the other issues, the details are likely to matter very much for the underlying welfare economics of the outcome. If a for-profit firm actually attracts disinterested contributions, and the deductibility of these contributions is contingent on the firm's actions, then the marginal subsidy rate for charitable activity depends on the extent to which tax benefits rise with greater activity, in addition to the usual subsidy that accompanies not earning taxable profits.

There is a more fundamental point at stake, which is the apparent arbitrariness of restricting tax benefits based on entity classifications. Malani and Posner forcefully argue that activities, not entity attributes, should govern the tax treatment of charitable undertakings. While acknowledging that the two are perhaps correlated, the article makes the point that an entity classification regime is too rigid to correspond to the underlying reality and needs of the charitable sector.

Charitable deductions are hardly the only activity governed by entity classifications. In the tax realm, business entities are taxed very differently based on whether they are partnerships, S corporations, C corporations, limited liability companies, foreign branches or foreign subsidiaries, and numerous other distinctions. Outside of the tax area, law schools that are

137. *See, e.g.*, Hernandez v. Comm'r, 490 U.S. 680 (1989).

138. Fleischer, *supra* note 114.

accredited are treated differently than those that are not. Doctors, drivers, and alcohol vendors must receive licenses to operate, and individuals who are citizens of the world nonetheless must hold citizenship in just one or at most a small number of countries.

Are all of these classifications arbitrary? To take a medical example, there might be a hog butcher who has not attended medical school and who therefore does not have a license to practice medicine, but who nonetheless has superior skills with the knife and has learned how to perform appendectomies. This person could have excellent training in this one very specific procedure, keep up with relevant medical research, be aware of all the possible complications and what to do about them, practice the procedure regularly on cadavers, and in every relevant way not only be competent to perform appendectomies, but also be better at them than many surgeons currently removing appendixes. Should the government permit that individual to file for a license to practice appendectomies? Should he be permitted to do them in his butcher shop? What if he promises to keep the shop as sterile as a hospital, maybe even more so because there are not a lot of sick people around to spread their germs?

Most reasonable people would have serious qualms about licensing single-procedure doctors or allowing them to perform their trade in a butcher's shop, for reasons that bear on an evaluation of for-profit charities. If someone cares so much about appendectomies, why didn't that person go to medical school? Maybe this one butcher is extremely committed to the excellent, part-time practice of performing appendectomies. But will most butcher-surgeons be as committed? Is it reasonable to expect the government to be able to evaluate and monitor the practices of every physician so certified?

Becoming a doctor, rather than a butcher, suggests a commitment to the practice of medicine. One of the virtues of entity classification is its recursive nature: the government certifies the American Medical Association, the American Medical Association certifies a medical school, and the medical school certifies its graduates.[139] Incentives for reputation, together with decentralized decision making, are generally thought to produce better outcomes than the alternative form of extreme centralization envisioned in vesting all authority in a central government agency that might adjudicate appeals for specialty exceptions to general rules.

In addition, doctors work with each other and not with butchers. They share information and the profession develops norms, both formally and informally. This is much the same as in the nonprofit sector, a sector that largely relies on self-governance rather than external policing.[140] It is un-

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139. This system creates the somewhat separate regulatory problem that licensure is a form of monopoly, and the AMA and its members may overreach. We thank Gene Steuerle for these observations.

140. *See* Panel on the Nonprofit Sector, Indep. Sector, Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations (2007). In addition to self-governance, the sector worked closely with Congress such that many features regulating the sector in the Pension Protection Act of 2006 stemmed from sector recommendations. Independent Sector, Public Policy—

likely that the average appendectomy-performing butcher (just like the average for-profit executive) will have time to attend the relevant professional events communicating the advances in surgery (or advances in nonprofit management). It is reasonable also to be concerned that multitasking butchers—or executives—might occasionally confuse their tasks or objectives, to the detriment of the object of their actions.

Putting aside these theoretical problems, how, exactly, would the IRS or an agency it designates actually go about determining the scope of permissible for-profit charitable activity to which new tax benefits would be attached? Quite apart from the obvious potential for undue political or bureaucratic influences over these determinations, there is the difficulty of processing the needed information and monitoring compliance, as a result of which there is likely to be considerable scope for tax avoidance from tax exemptions that do not conform exactly to underlying activities. Again, these administrative costs would need to be weighed against the advantages in terms of the additional efficiencies generated from expanding the universe of parties who can participate in the market for such tax subsidies (beyond non profit organizations). But for reasons discussed above, it seems extremely unlikely that the advantages would outweigh the costs.

Even if the charitable activities of for-profit companies could be accurately assessed and costlessly enforced, there remains the issue of how for-profit and nonprofit entities might affect each other in the markets for contributions and service provision. Greater charitable activity by for-profits need not displace activities by nonprofits, though that is a plausible outcome. From a policy standpoint, is it better to have charitable decisions made by a for-profit entity with twin goals of making profits and advancing charitable ends, or by an organization without shareholders to reward? If donors were altruistically motivated and had complete information and the ability to contract fully with donees, then this would be a question for donors to consider; but in the absence of pure motives, full information, and contracting rights, it also becomes a matter of public policy. The actions of for-profit charities could be designed to enhance company profits indirectly, with private donors who either do not know that their contributions are not wisely used or do not care as much as they should, instead reacting to appealing marketing campaigns. Either way, any evaluation of the normative implications of attracting donations in such settings must address the possibility of such a system to reduce contributions to organizations in which the resources would do more good.

One of the asserted virtues of authorizing for-profit charities is the nature of profit-sharing arrangements that give for-profit managers incentives to minimize administrative costs. So the argument goes, nonprofit managers do not benefit from the same incentives, either because their objectives are

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Accountability and Oversight, http://www.independentsector.org/programs/gr/charityreform.html (last visited Oct. 19, 2009).

more diffuse or their costs are not easily identified,[141] though this argument presumes the use of suboptimal compensation schemes and inadequacy of competition in the nonprofit sector. Certainly for-profit ventures have incentives to minimize cost at any given level of output, but that is not all, since they also have incentives to adjust output in ways that are sensitive to costs. Since charitable output is notoriously difficult to measure, a for-profit manager who shares in corporate profits may have an incentive to disguise output to earn extra compensation. She would also—again, if true charitable output is not completely verifiable—have incentives to reduce administrative costs to an inefficiently low level.

Significant costs would be associated with reforming the treatment of for-profit firms that engage in charitable activity. Greater incentives for charitable activity come at the price of creating new tax clienteles, increased regulatory complexity and enforcement costs, and the creation of new opportunities for tax arbitrage. Pursuing such changes, then, should require forceful justification and explanation of why the current regime is inefficient or untenable. We do not find persuasive the claims in the recent article by Malani and Posner that the current regime is broken.

CONCLUSIONS

A customer entering an ice cream parlor does not throw money across the counter and hope that the creamery will produce a mocha-almond-fudge cone of just the right size. Nor does anyone enter a store with a "shoemaker" sign, slip a check into the till, and wait for just the right shoes. Those who want ice cream place very specific orders; similarly, people buy shoes based on style, color, and size—and only after trying them on.

Why shouldn't the government behave this way when it buys charitable goods? Decide it wants something specific—buy it, evaluate it, and repeat. Rather, the government throws tax exemptions at something akin to a charity store and hopes it gets what it needs. Many observers find this approach puzzling, and—at least on the surface—it is.

The idea of providing tax subsidies to for-profit charities has the same sort of intuitive appeal. If they perform the same public functions as nonprofits, why wouldn't the government give them the same incentives? Wouldn't doing so expand the scope of possible providers, encourage competition, and enlarge the range of positive contributors to society? Furthermore, since for-profit firms do not labor under the same restrictions to which nonprofits are subject—in particular, the requirement that nonprofits not distribute profits to managers or other stakeholders—for-profits appear to be able to tailor their activities in ways that promote greater productivity and efficiency than many nonprofits.

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141. Similar concerns arise in the comparison of public versus private production. *See, e.g.*, Oliver Hart et al., *The Proper Scope of Government: Theory and an Application to Prisons*, 112 Q.J. ECON. 1127 (1997) (discussing why public production is sometimes preferred); Caves & Christensen, *supra* note 107, at 960.

Further examination suggests that the government may show uncommon wisdom in subsidizing nonprofit firms to provide goods with positive externalities just because those firms are nonprofit. At a minimum, the reasons advanced for not adhering to this 400-year-old tradition are not compelling. Nonprofits have plenty of tools at their disposal, such as incentive compensation, to generate the behavior that government wants. The law is on their side.

Moreover, the reasons that have been advanced in favor of rejecting status-based subsidies are founded on economic analysis that is too limited. The argument considers only a partial equilibrium setting with a single price-taking firm, failing to account for the nature of competition and rational behavior by nonprofit managers or to note that the usual benefits of for-profit competition arise from the competition, not the profits. The restrictions that prevent nonprofit organizations from distributing profits do not force them into inefficient investment patterns or subpar management practices, since with multiple potential uses for their funds and many alternative possible management practices, they confront no shortage of avenues for social value creation. Efficient resource allocation requires proper motivation, and here the prevailing high level of competition from other nonprofit competitors not only encourages and rewards efficient behavior, but also diminishes the survival prospects of inefficient organizations, thereby serving the same cleansing function of for-profit markets.

Perhaps most importantly, the proposed alternative—giving a tax break to for-profit charities—would create new avenues for tax avoidance. Permitting tax deductions for donations to for-profit entities permits a form of arbitrage in which donors with high marginal tax rates can claim deductions for what are actually gifts to owners of recipient organizations. Policymakers committed to equal tax treatment of the charitable activities of nonprofit and for-profit organizations might well respond to the resulting tax base erosion by scaling back on the deductibility of contributions to both, with predictable consequences for contribution levels and the volume of charitable activity.

The costs of extending tax privileges to for-profits that provide charity appear not only in the tax system but also in the efficiency of resource allocation. The costs include the proposal's effects on for-profit charities and their contributors, as well as effects on the nonprofit sector. Since for-profit entities already receive an implicit tax subsidy for their altruistic actions, the greater opportunities available from adding explicit tax benefits would create tax arbitrage opportunities and distort the behavior of those who seek them, necessitating the devotion of enormous resources to oversight and control. Subsidized charitable activity by for-profit firms inevitably affects nonprofit organizations and the activities that they undertake and support. Given the degree of competition in the nonprofit sector, greater entry by for-profits cannot be expected to enhance the degree of competition meaningfully, instead changing its nature to something less consistent with what is envisioned by granting public support to charity and its providers. Properly encouraging and rewarding charitable activity does not entail making

explicit tax benefits available to everyone, but instead involves identifying cases in which recipients of donated funds pursue clearly identified charitable ends without the potential for conflict of interest that inevitably accompanies the profit motive.