Economic Theories of Nonprofit Organizations

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Those unfamiliar with economics, nonprofit organizations, or both may wonder what one subject has to do with the other. Economics does not, of course, provide the reader with everything he or she ought to know but it does provide insight on virtually every problem relating to the role, behavior, management, and regulation of the nonprofit sector. In turn, economics has become a richer discipline for confronting the special challenges posed by analysis of nonprofit organizations.

Economics is the study of choices under scarcity. This goes far beyond the study of things bought and sold and far beyond the financial consequences of decision-making. When consumers decide whether to spend all their limited money on goods and services for themselves or donate some of that money to nonprofit organizations, they are choosing how to allocate a scarce resource. When consumers choose to spend some of their scarce time as volunteers rather than laborers or leisure-takers, they are making an economic decision. When socially conscious entrepreneurs ponder whether to form a new organization, support an existing organization, or lobby government to meet some societal need, they are choosing how to allocate their time and other scarce resources at their command. When financially strapped nonprofit organizations decide to charge their intelligent clients a little something rather than eliminate programs, they are making an economic decision forced by scarcity.

Economics as a discipline does not rule out study of the sector, but many simplified models studied by economists divert attention from philanthropic and nonprofit issues. Economists assume that each individual pursues his or her self-interest as they see it. In practice, this is often simplified as the assumption that each cares only about his or her personal consumption of goods and services. However, self-interest encompasses helping others one cares about, and individual perceptions of self-interest can be socially determined. The charitable behavior of donors and volunteers reminds economists that more complicated models are necessary, paying back the analyst with insights that go far beyond understanding charity. In this fashion, economic models typically assume that for-profit firms maximize profits because that is what the owners want to do. Framed in this way, departures from profit maximization appear as "market failures" due to "agency problems" cured by providing the proper financial incentives. Nonprofit organizations cannot be analyzed from the same starting point. These organizations may indeed maximize their "profits" (or financial surplus or endowment) under some circumstances. However, this is a result that must be shown and its significance must be interpreted anew. Thus, for example, Silviusk (2002) shows that a mixture of financial and non-financial incentives is the best way to motivate nonprofit employees in specified circumstances.

This chapter provides an overview of the economics of nonprofit organizations. Many later chapters provide far more detail on the decisions to give or volunteer (Haviv, O’Herlihy, and Schervish; Vesterlund; and Leete), the economic relations among the sectors (Brown and Silviusk; Smith and Gristberg; Galaskiewicz and Colman; Tackman and Chung), cross-sectoral comparisons of organizational behavior in specific industries (Kendall, Knapp, and Forder; Schleuning and Gray) and selected public policy issues (Brody; Simon, Dale, and Chirolm). Here, I survey the big picture and fill some holes left by the collection of other chapters.

In the next section, I provide definitions and distinctions used for the economic approach. Later I discuss an older set of theories, known as the "two-failures theory," regarding the distinctive role of nonprofit organizations in the broader economy. Then, I argue for development of a more comprehensive and integrated theory, lay out the parameters of such
not analyzed the impact of the governance distinction. This is an unfortunate gap in the literature as political dynamics do not explain the role, objectives, performance, and life cycle of nonprofit organizations.

THREE FAILURES: AN EARLY SUCCESS

Before Weisbrod's pathbreaking work in 1975, economists typically viewed nonprofit organizations in isolation (for example, Tullock 1965; Newhouse 1970; Feldstein 1971; Paley and Heslin 1978). But if these organizations were to start, a nonprofit organization was supplying a particular good or service. They would then ask how that nonprofit's behavior would differ from that of a for-profit firm. For example, Newhouse characterized the behavior of a nonprofit hospital that cared about both the quality and quantity of health services it delivered. This was a useful starting point, but it was never clear why nonprofits were supplying the service in question, and not some other kind of organization. Why did organizations with quantity-quality objectives emerge in the hospital industry, but not in automobile manufacturing or accounting services? Given that nonprofit hospitals did arise, why is the hospital industry also populated by for-profit and government hospitals? Would the nonprofit presence in the hospital industry end if special tax advantages were removed, if Medicare shifted to a prospective payment system? Organizations that are not motivated to compete are searching for a distinctive set of roles that nonprofit organizations could play in a mixed economy. He catalogued the known virtues of nonprofits before turning to the creation of new ones. Weisbrod began his work on nonprofit organizations as a part of a broader project to distinguish nonprofits from for-profits.

Adam Smith, in exploring the virtues of for-profit markets through his famous "invisible hand," laid the groundwork for thinking about market failure. In more modern terms, the idea circulates as the first fundamental theorem of welfare economics, which asserts that when all goods are traded in perfect competitive markets, equilibrium outcomes are efficient. As used in the theoretical sense, "efficiency" is anything that consumers value either positively (goods) or negatively (bad), including services and tangible objects; perfectly competitive market is the one in which no individual buyer or seller believes he can affect market prices; "equilibrium" refers to a set of prices such that the amount of each good that consumers want to buy exactly equals the amount producers would like to sell; and "efficiency" is used in the broad economic sense. The first fundamental theorem does not state that prices and quantities are efficient in all circumstances, only that they would be efficient as an outcome if not for the seemingly odd notion that a market price for a good in a perfectly competitive market is not a reflection of the consumer's true valuation of that good. The second fundamental theorem states that under some circumstances, it is possible for a market that was considered allocatively efficient to produce prices and quantities that are not efficient. The first fundamental theorem is essentially a statement of the basic free-rider problem that arises with collective goods. Hence, many economists argue that the market failure of market failure lies in the market's inability to provide collective goods, because those goods are not "excludable." Nonprofits, therefore, are considered to be a potential solution to this market failure.

Market Failure

Market failure is the best understood of the three failures, and concerns inefficiencies resulting from ex-post provision of goods and services. The term inefficiency as used here and elsewhere by economists has a very broad definition. Markets can be inefficient because they waste resources by using the wrong production processes (productive inefficiency), but they can also be inefficient because they waste resources by producing the wrong mix of goods and services (allocative inefficiency). Allocative efficiency requires an output mix that properly balances the relative benefits to consumers against the relative costs of production. For-profit firms are, at least in theory, productive and efficient but often produce the wrong mix of outputs in three ways: some worthwhile goods are undersupplied, access to some goods is overregulated, and the quantity or quality of some delivered goods is different from what consumers believe is optimal.

Richard Steiner

a theory, and discuss progress to date in carrying out those ideas. I conclude by illustrating how economic theory provides insights for designating appropriate public policy for the sector.

DEFINITIONS AND DISTINCTIONS

Many definitions abound in discussion of "the sector," but in this chapter I use Hanauer's (1980) idea: A nonprofit organization is one precluded from distributing, in financial form, its surplus resources to those in control of the organization. By this definition, nonprofit organizations can earn and retain financial surplus ("profits") provided they do not pay dividends check or their equivalent to the board of directors or top managers. Instead, the surplus is either retained (as endowment, reserves, or temporarily restricted funds), reinvested (in organizational expansion or the provision of charitable services), or given to other nonprofit organizations (as grants). Some nonprofit organizations derive all their resources from commercial operations, and in that sense are just as much "for-profits" as any for-profit firm. The distinction is that they must retain or revalue their profits.

Hanauer (1980) called this prohibition on profit distribution the "nonprofit constraint," and made it central to his theories of nonprofit behavior. As we will see, the nonprofit constraint is an essential part of other economic theories that provide a clear distinction that affects how the organization obtains resources, how it is controlled, how it behaves in the marketplace, how it is perceived by donors and clients, and how its employees are motivated. Hanauer also defined the concept the "fair compensation constraint" that applies to nonprofit distribution to executive compensation.

This definition of nonprofit organization excludes consumer cooperatives and worker-owned firms, but includes mutual savings banks. All these distribute their profits to their members. The constraint on nonprofit organizations presumes that boards of directors do not receive distributions and those receiving distributions have no rights of control. Some organizations are legally incorporated as nonprofits but Sidney define their distribution practices to their members and hence do not count as nonprofits. The issue here is whether nonprofit organizations, which have directors who are also board members, engage in practices that distinguish them from for-profit organizations. The "nonprofit constraint" distinguishes mutual nonprofits (where the power to elect the board is in the hands of the owners and customers) from entrepreneurial nonprofits (where the power to elect the board is self-perpetuating and the difference between these two types of organizations is real-world nonprofits may straddle the boundary) and asks whether these types behave differently. Subsequent literature in the field of nonprofits shows that while some organizations are nonprofit by law and others by the nature of their charter, their behavior can be quite different.

Some organizations that are not organized to distribute their profits, like for-profit government nonprofit organizations: Hanauer (1980) added another theoretical short-coming of markets to the mix: contract failure. In cases where the quantity or quality of service cannot be verified, markets take the opposite extreme - perfect competition, because between donor and commercial nonprofits, but work to date has

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Public good—birth of a new citizen does not diminish the quantity of protection enjoyed by other citizens (nonrivalry), and excluding any citizen from the protection provided by this service would be difficult (nonexcludability). For-profit firms do not produce pure public goods because consumers have the motive and opportunity to consume them without paying. This sort of market failure justifies governmental provision of national defense, hence the norm "public goods." However, some "public goods" are produced by private nonprofit, so it has become increasingly popular to call them collective, rather than public, goods.

Some collective goods, like the performing arts, are excludable though still nonrival. Keeping nonpaying custom-
ers from enjoying a performance is possible, but once the performance is staged, it does not diminish the enjoyment of existing consumers to let an additional person enjoy the show. Markets for excludable collective goods fail in a different way—although the market may provide the good, it limits consumption to paying customers. However, excluding borderline nonpurchasers (those who would enjoy the show but are not willing or able to pay the required entrance fee) is inefficient. Letting them attend would help them, hurt no one, and consume no additional scarce resources. Nonetheless, for-profit firms fear loss of revenue from paying customers if they let the borderline nonpurchasers in, resulting in an overexclusion market failure. Excludable collective goods may also suffer from the underprovision problem, although this is not our primary focus here.

A private good (for example, a surgical procedure) is the opposite of a pure public good—consumption is rival (no one but the patient is cured of appendicitis when the appendix is removed) and nonpayers can be kept from consuming it. Markets fail to provide the right mixture of private goods in certain cases of asymmetric information, where the seller of services knows more about the quality or quantity of delivered services than the buyer does. Haussmann (1980) extended the original insights of Nelson and Krasnansky (1973) as the theory of "contract failure." Contract failure exists when: "Owing either to the circumstances under which a service is purchased or consumed or to the nature of the service itself, consumers are unable to evaluate accurately the quality or quantity of the service a firm produces for them. In such circumstances, a for-profit firm has both an incentive and the opportunity to take advantage of customers by providing less service than was promised and paid for." (Haussmann 1987:29).

Contract failure arises when truthful information about the quality or quantity of delivered services cannot be purchased. Consider three cases where contract failure arises. First, suppose that instead of donating a sum of money to a nonprofit and asking it to feed the hungry in some foreign land, the prospective donor tries to purchase the same service from a for-profit. That customer is paying so that additional hungry people will be fed. The customer cannot easily observe whether they are fed, but could hire someone to find out how many people were being fed by the company in question. Still, perhaps some of those people are being fed because of another customer's purchase of food aid. The customer cannot learn whether his or her purchase added to the sum of people being fed, so that any explicit or implicit contract to buy food this way would fail.

The second example is a long-term care facility such as a nursing home. Weisbrod and Schlesinger (1986) noted that nursing homes, and services more generally, are bundles of easy-to-observe (type I) and hard-to-observe (type II) characteristics. Although for-profit firms can be trusted to provide the promised level of type I characteristics (room size, presence of medical staff), contract failure is likely for type II characteristics (whether residents are treated with due respect; whether sedatives are administered properly). Two other factors also contribute to contract failure here—the fact that the purchaser of services (often the adult children) is not the consumer of services (the resident) and the fact that if experience proves that contract failure is present in a particular facility, switching to another health provider is difficult for medical, social, and financial reasons. These factors also affect other types of services such as day care for children and inpatient psychiatric care.

The third example comes when governments contract with private agencies to provide social services. Social services are complex and include many type II characteristics that matter to government contractors (e.g., Paulson 1988). For example, it is hard to tell whether foster home placements represent the best available match between caregivers and children. It is also difficult to figure out whether difficult-to-treat clients are steered toward other providers to cut costs or misclassified to reap higher contractual payments.

Governmental Responses to Market Failure

I detailed three sources of market failure above: underprovision of collective goods, overexclusion from excludable public goods, and contract failure. Each of these provides roles for the other two sectors, and here I detail the governmental response. Governments solve the underprovision problem by either producing collective goods or paying a private-sector organization to produce them (contracting out). In effect, government payments compel the market, allowing trading for the collective of beneficiaries. For example, governments directly provide transportation infrastructure (highways and airports), collective recreational and conservation activities (parks), and reduction in the risk of theft or bodily harm (police). Periodically, government privatization efforts have led to the contracting-out of garbage collection, prison facilities, postwar reconstruction, and even public primary and secondary education.

Governments also address the market failure of overexclusion from excludable public goods in a variety of ways. First, when government produces the excludable public good, it sets the terms of exclusion. Many museums and zoos do not require payment of an admission fee, offer free days periodically, or exempt favored groups (such as schoolchildren) from fee requirements. Second, government regulations for-profit providers, sometimes mandating

![FIGURE 5.1. SCHEMATIC OF THREE FAILURES THEORY](image-url)
that taxpayers retain access to the collective good (for example, emergency phone service). Third, government gives selected groups special subsidies that enable them to compete for access to excludable public goods (such as business vouchers for the in-state or work-study positions for eligible college attendees).

Governments address contract failure in a variety of ways. Government contracts facilitate the enforcement of contracts, reducing the number of markets that fail in this way. Second, governments regulate the representations that firms make about their ability to truthfully advertise and comply with the law, labeling requirements, and the like. Third, governments limit entry into markets that suffer from asymmetric information problems through licensing and bonding requirements. Finally, government warms consumers of particular abuses and teaches consumers how to detect mistreatment. When government is the contractor, it deals with contract failure by monitoring for profit providers more intensively (Friser and Gnedly 1991) and by negotiating longer, more detailed, and more complicated contracts (DeBoer 1994).

Government Failure

Subjecting government to the same formal scrutiny as mar- kets, one uncover a variety of sources of “government failure” (e.g., Wolf 1993). Many disciplines have contributed to research on government failure, which includes both the physical scarcity and quality of government products and the opportunity costs associated with these failures. The failure of political decision-making can be used to predict the levels of collective goods provided (or paid for) by government. Whenever the form of government, one result prevails—some form will be distorted by self-interest and inefficiency. An important source of government failure is that government is not subject to the same form of competition as private goods. Government failure is a failure of the political process to function competitively at any level. When government acts, it is not subject to the same form of competition as private goods. Government failure is a failure of the political process to function competitively at any level. When government acts, it is not subject to the same form of competition as private goods.

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religious services in the United States) even the median-preference voter will be dissatisfied. Conversely, sometimes the government prohibits other sources from responding to countervailing influences at all. For example, large retail stores (James 1989). Then, the government role is too large compared with the unconstrained optimum.

Nonprofit Responses to Market and Government Failure

Markets fail and governments are only partially successful in their attempts to correct for market failures. In fact, failures in each of the three areas of economic failure are not mutually exclusive. In some cases, the nonprofit organizations can be a response to market failure. In the United States, the severe problems of national defense, but the quality of fire protection, schooling, streets, and parks, and public picnic areas is decided locally in ac- cord with local preferences. To the extent that those who prefer lower levels of collective goods locate in different communities, voter dissatisfaction with governmental provision levels is reduced. Tiebout (1956) considered the logical extreme, finding that communities with different levels of public goods, Hannamill (1981a) for excludable collective goods, and Handmill (1980) for contract failure. In this section I discuss each in turn, then the failures of nonprofit organizations that lead to rules for the other two factors.

Weisbord (1975) observed that nonprofits in almost every nonprofit industry, especially donative nonprofits, provide collective goods. Consider first those nonprofits that help the needy. At first glance, this seems to be a private good— food is consumed by one individual, and nobody else can be enriched unless more soup is made. Soup is indeed a pri- vate good, but "helping the needy" can be enjoyed by every- one who cares about this group of people. Other altruists enjoy the fact that anyone has helped these people. If, in addi- tion, local charities manage well their funds, selfish indi- viduals would also consume this collective good.

Consider next medical research. If a nonprofit organiza- tion’s goal is to help solve the medical problems of a society, then society would have a private good—gels cannot be collectively con- sumed in any useful manner. However, the knowledge that the program produces that is a collective good—the knowledge is not used up by anyone’s gift consumption. A patent system makes that collective good excludable, and so we do see for- profit medical research firms. However, for-profit practice ensures that rent seeking, some health system is only partly suc- cessful in covering it.

The performances arts provide another example of an ex- clusive benefit—some people do not want to listen to a piece of art. The typical concert presentation are bound up in rebukes, seats, cos- tumes, and hall rental. If the hall is not full, an additional audience for the show at no cost to existing audien- ces. Zoo and museums are similar in this respect.

Education produces both collective and private benefits. A good education enhances lifetime earnings—a private benefit. Education is one of democratic decisions and provides a common language and set of un- derstandings that helps business and social interactions. High-quality education may also involve mostly private benefits, but the treatment and prevention of contagious dis- eases provides a collective benefit for those who have not yet contracted the disease. While there are many cases about the collective benefits for the advocating group and collective costs for their opponents.

Many forms of nonprofits, particularly those governed by members or in the religion and education industries, mature repeated interactions among stakeholders. This is hardly unique to nonprofits, but Bier-Ner and Cit (2003) stress that nonprofit organizations create better personal relationships even where laws and regulations are less lenient. High-quality nonprofits often serve as creators of the collective good “social capital,” a network of relations that facilitates joint action. Religious and other nonprofits complement these relations through social capital by nurturing moral codes and be- haviors.

After observing that nonprofits confer a range of services on the public, and that many of these are of low or negligible value, it follows that nonprofit services are likely to be under-priced, or even free of charge. Yet, it is hard to believe that nonprofits would be able to attract funds unless they perceived the benefits of their services as valuable. In particular, it is hard to believe that nonprofits would be able to attract funds unless they perceived the benefits of their services as valuable. In particular, it is hard to believe that nonprofits would be able to attract funds unless they perceived the benefits of their services as valuable. In particular, it is hard to believe that nonprofits would be able to attract funds unless they perceived the benefits of their services as valuable. In particular, it is hard to believe that nonprofits would be able to attract funds unless they perceived the benefits of their services as valuable. In particular, it is hard to believe that nonprofits would be able to attract funds unless they perceived the benefits of their services as valuable. In particular, it is hard to believe that nonprofits would be able to attract funds unless they perceived the benefits of their services as valuable. In particular, it is hard to believe that nonprofits would be able to attract funds unless they perceived the benefits of their services as valuable.
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points out, it is good to have your immune in a nonprofit day-
care center but even better if the center-owner’s children are
also customers.

Nonprofit organizations are immune from finan-
cially based takeover bids as they do not have shares of
stock that can be traded for profit. Thus, the dedication of
the founding entrepreneurs to thriftiness behavior is not
endangered. The only bidders, not just for nonprofits but
other sectors as well, are those who desire to pay the
entrepreneur his due. Financial formulas are indifferent to
the collective good in question. However, this same fear
seem to affect donations to nonprofit organizations. In
response to one’s donation, other donors might reduce their
generosity, fearing that the government might reduce its
and grants and con-
tracts with the recipient organization. Bilodeau and Silivanski
(1998) point out that the nondistribution constraint keeps
previous donors (notably the founding entrepreneur) from
withdrawing their contributions in response to contributions
to others, but the problem remains for those who donate
contemporaneously. No doubt the repeated structure of in-
vestment that fosters social capital helps, but this would not
seem to explain, say, one-time donations to a nonmem-
bership organization. Voorhees’s chapter in this volume
explores these structures in greater depth, but puzzles remain
when we try to make our intuitions on matters more explicit.

Why do nonprofits deal with the overexclusion problem?

First, we need to understand the market failure a bit better. If
for-profit firms knew the maximum amount each con-
sumer was willing to pay and had the power to charge a
different price for each attendant (“perfect price discrimina-
tion”) then overexclusion would not occur. Those willing to
pay a penny would be charged a penny, those willing to pay
a million dollars would be charged a million dollars, and
everyone who enjoyed the excludable collective good in the
slightest amount would voluntarily pay the entry fee. How-
ever, because there are so few enough about consumer will
laxness-to-pay to practice this strategy. Consumers would
not reveal this information to a for-profit firm because it
would not allow them to overexclusively overexclude because
they cannot demand
not more than is necessary to provide the collective good
in order to maximize their distribution of profits. Ben-Ner
(1996) argues that the same does not apply to nonprofits, be-
cause of both the nondistribution constraint and the typical
structure of nonprofit governance. Consumers might reveal
their willingness-to-pay directly, enabling the nonprofit to
experience efficient prices, but the higher one-time fee struc-
tures (such as college tuition, or fees for medical care, et al)
might reveal this information implicitly through the donations they make on top of
their purchase. Thus, Hansmann (1981a) refers to donations
for excludable collective goods as “voluntary price discrimi-
nation.”

Hansmann (1981a) analyzes how nonprofits respond to the combined problems of underprovision and overexclusion
affecting high-cultural organizations in the performing arts
such as opera companies, symphony orchestras, and dance
troupes. When, as so often happens, most of the costs of pro-
duction do not depend on the number of performances and
consumer demand is moderately high, we have a good that
is socially beneficial but not profitable to sell at all by market-
s. No single price will attract enough consumers to cover the
costs of production, and for-profits cannot successfully prac-
tice price discrimination for two reasons. First, as I noted
above, Ben-Ner makes clear that one-time fee structures, not
profits with the necessary information. Second, tickets can
be resold. Nobody would buy tickets directly if they were
charged more than the costs attributed to their production and
take someone charged a lower price to buy extra
tickets for them. Voluntary price discrimination is needed,
and that can be provided only by a nonprofit.

Another way that nonprofits deal with the overexclusion problem is to use cross-subsidization (Dunque 1983, 1998;
Weisbrod, 1998). Here, rather than charge different con-
sumers different prices for the same product, the nonprofit
charges higher prices for some products to generate finan-
cial surplus that can be used to lower the price, and so re-
duce exclusion, for other services. For example, noon and
aquariums use profits from gift shops and other concessions
to finance an average admission fee that is far below the
profit-maximizing level (Cain and Marit 1989). Cross sub-
sidization is done for many reasons, of which one is to re-
duce exclusion from collective goods, and is discussed fur-
ther in the chapters in this volume by Brown and Silivanski
and by Backman and Backman.

Nonprofits help to solve contract failure in five ways. First,
the nondistribution of profits reduces (or eliminates,
depending on output), the distribution of the surplus
of consumers benefits from delivering less than the promised quality
or quantity of services. Second, the nondistribution constraint
affects the rewards of founding and controlling a nonprofit
rather than another kind of organization. A process of “en-
trepreneurial sorting” takes place, and those ending in the
nonprofit sector will have different personal objectives re-
garding what they expect to accomplish in their role. Hann-
mann (1980) wrote about both these arguments, speculating
that the sorting would enhance the thriftiness of nonprofit
organizations. He did not see in later sections, this is not neces-
nercally the case, although sorting is likely to be important.

Third, nonprofits are often managed by “demand-side stake-
holders” that are stakeholders in the organization which is
governed by the organization’s board of directors. Such as
philanthropists, universities, or government agencies, are
governance of nonprofit organizations. Again, nonprofit orga-
nizations fail for many reasons, but the most common one is
insufficient information about the need for their existence.
Salamon (1987) was the first to orga-
nize four of these ideas as his theory of “voluntary fail-
ure,” although we will use this label to include additional ar-
amenations. Thus, voluntary failure is a failure of govern-
ance, and philanthropic failures, philanthropic pa-
ternalism (or, as I prefer, “parentalism”), and philanthropic
insufficiency.

Philanthropic insufficiency suggests reasons why non-
profit organizations have difficulty addressing the underpro-
sion problem of which the financial considerations, when
the need is greatest. A major problem is that the “free-riding
behavior,” discussed in more detail in Voorhees (this vol-
ume). This includes several interrelated issues. First, as dis-
cussed above, donors might fear that the added to
total provision of some collective good, their donations
would enable governments or other donors to withdraw their
own contributions. Second, potential donors enjoy the collective
good whether or not they contribute. It is one example of the
case that can be made that the benefactors of the collective
good are not the only beneficiaries of the benefactors of the
donations. My summary of these literature is that phil-
anthropic insufficiency is a problem, but it is not as severe a
problem for the simplest economic reasons. Nonprofits do not
have to pay donor to provide some support for the collective
good in question. In any case, nonprofit organizations can take many specific
actions to reduce the importance of this problem.

Philanthropic paternalism refers to the tendency of non-
profit organizations to focus on particular ethics, religious,
geographic, or ideological groups, leading to duplication in
some cases and gaps in coverage in others. To some ex-
ample, paternalism is a natural consequence of political
deficits—individuals are too busy to organize, and even those
who choose to work or volunteer for nonprofit organiza-
tions to treat problems as they perceive them, rather than as
the clients perceive them. This is unlike government action,
where clients have at least some small say through the ballot
box. Anonymity refers to the tendency to rely less on cre-
dentialed workers, perhaps appropriate if client needs stem
from smaller problems rather than from larger-scale tech-
ical factors. All these issues are discussed further in the chapters
by Lemson and by Brown and Silivanski.

How do nonprofits organizations full short of curing the
three market failures we have discussed? With respect to the
underprovision problem, voluntary philanthropic insufficiency obvi-
ously limits the nonprofit’s ability to solve the free-rider problem, but
and when too many organizations representing too many causes compete for scarce donations, this causes problems.
One organization’s solicitation efforts might reduce another organization’s
fundraising at other organizations (and so decrease the net funds available for collective good provision). This “co-
centration of fail” was first highlighted by Rose-Ackerman (1982) and
is discussed further in Brown and Silivanski (this volume).

Nonprofit ability to solve the overexclusion problem de-
depends upon whether consumers really trust the nonprofits
even to reveal their willingness-to-pay. Without such trust, nonprofits
cannot charge high prices to high demanders, and so nonprofits
and other sources of financial revenue (such as grants) cannot subsidize prices below the costs for the low
laxness-to-pay. In addition, there must be limited competition for low demanders. If, for example, a competing for-profit
firm picked a price (or set of prices) only modestly above costs, the nonprofit could not set a higher price than its
competitive price. This would reduce the nonprofit’s ability to subsidize prices for low-demanders (Steinberg and
Weisbrod 2005).

Nonprofits differ in their ability to combat fail-

from lower costs, and there are no hostile takeover bids to force them to pay attention. Whether and to what extent this form of inefficiency occurs is quite controversial. The reader may wish to look at the extensive discussion in Schleienberger and Gray in this volume for further discussion.

Second, regulated ownership raises the cost of capital, else equal. Nonprofit organizations cannot sell meaningful shares of stock to raise capital, and so must rely heavily on debt. Hausman (1983b) argues that this raises the effective capital costs of U.S. nonprofits from the corporate income tax serves as a crude cor-

rective. Higher capital costs lead to an inefficient mix of inputs and inadequate or slow response in demand for outputs. This creates both productive and allocative inefficiency. Again, this form of voluntary failure is controversial, and the reader should see Brown and Siwakins (this volume) and Billsers and Steinberg (forthcoming) for further details.

Third, attenuation ownership means that owners who follow change cannot transfer ownership and innovate as are accordingly are not rewarded for this attention. Sometimes, nonprofit organizations are proud of their failures here, as in higher education. Nonprofit universities are proud to pro-

duce, paternalistically, what they think their students need rather than what they thought they needed. However, the pres-
sence of competition with new for-profit universities and less-paternalistic employers will solve this problem. The definit-

ion of economic efficiency does not allow for patron-

age, so whether one regards these differences as good or bad, they show up as a form of inefficiency.

Closing the Circle: Reaching to Voluntary Failures

Three-failures theory does not prescribe that any sector is "first" and the other sectors react to its failures. Rather, the approach arranges the three sectors around a circle, with each sector influencing the others. The concept of "time" is especially important. Weisbrod’s (1975) exposition, followed here, has nonprofits responding to failures by the other two sectors, which allows the argu-

ment that nonprofits are "first" to fail and are "first" in developing our intuition about the whole circle. Salamon (1987) recol-

ignized this shortcoming, and began his exposition with nonprofits as the first sector, whose failures are addressed by govern-

ment and for-profits. This brought the new insights regarding voluntary failure. Regardless, we need now to specify how the other two sectors respond to this voluntary failure.

Historically, the Salamon approach may be more accu-

rate, although it is a bit hard to tell because the definitions of the respective sectors have been so fuzzy in the past. In modern times, it is often (but not universally) the nonprofit sector that is the first to respond to a natural disaster or the first to carry out a social innovation because of the natur-

al inertia in government action. Salamon (1987) noted that governmental action requires, in order, public arousal, infor-
mation gathering, passage of laws, and establishment of a bureaucracy to carry out those laws. Some of these steps are carried out in advance for response to natural disasters, so it remains an open question whether one expects nonprofits to be the first responders. Regardless, the point is that the voluntary failure hypothesis that response and government supplies additional resources in a less particularistic and more credibly

Salamon did not address how for-profits close the circle. Others may choose to deal with this sector first. For-profits may possess a more productive inefficiency wherever it occurs and to allocative inefficiency in markets for private and some excisable col-

lective goods. Low-cost producers or groups of U.S. non-

profits from the corporate income tax serves as a crude cor-

corrective. Higher capital costs lead to an inefficient mix of in-

puts and inadequate or slow response in demand for outputs. This creates both productive and allocative inefficiency. Again, this form of voluntary failure is controversi-

cral, and the reader should see Brown and Siwakins (this vol-

ume) and Billsers and Steinberg (forthcoming) for further
details.

Empirical Evidence

Salamon supports many propositions discussed above. Clearly, nonprofits provide collective goods, but Weisbrod’s model suggests that we can predict the relative roles of gov-

ernment and nonprofits in financing these goods. Specifi-
cally, the hypothesis is that the nearer the good is to a public good the more dissatisfaction there will be with government provi-

ion levels and therefore nonprofit financing of collective goods will be larger. Note that the predicted size of the nonprofit sector, which is largely paid for with government money as grants and contracts, but only about the donor-financed portion of nonprofit expenditures. Thus, the result of Salamon and Anshirer (1998) that the nonprofit sector is smaller in more heterogeneous countries is not quite on point (Steinberg and Young 1998). In con-

trast, Steinberg and Young (1998) finds that government sup-

port to private education, more heterogeneous countries rely more heavily on nonprofit primary and sec-

dary education in racially diverse communities versus measures of heterogeneity. Religious heterogeneity has the largest effect, and measures of linguistic heterogeneity and income diver-

sity have smaller and less statistically significant effect sizes. Feigenbaum (1980) used variation over time to explain state spending on income redistribution and total donations in the United States. She finds no statistically significant impacts of heterogeneity on government spending, but a very sig-

nificant positive correlation between heterogeneity in age and donations. Finally, Chang and Tuckman (1996) find that non-

profit vs. religious organizations rely on donations for a greater share of their revenues.

Many other chapters in this volume present evidence on contract failure (especially Brown and Siwakins, this volume, and Gray and Kneale, and Fiedler, and so I will present only an overview here. It is extremely hard to test contract failure theory because it concerns unobservables.
If the author of any study could reliably detect differences in the trustworthiness of organizations, presumably government could too and they would directly regulate the behavior in a manner reducing the temptation to cheat. Faced with this dilemma, five strategies have been employed, with the greatest volume of studies testing contract failure in the healthcare, drug-care, and housing/industrial fields. Firms employ medical procedures for diagnoses that will be observable by some consumers (the informed) but not all. This strategy is particularly effective when the outcome is unit-specific and valued differently by different consumers, so that uniform government regulations would reduce desirable diversity in the marketplace. Second, some studies have used indirect tests based on the number of complaints filed with the government determined to be nonactionable because they concerned matters on which regulations had not been set. Third, some studies have used indirect tests based on the respective sectoral market share changes when technological improvements have reduced the cost of monitoring or when state regulations have been changed. Fourth, studies have compared the experiences of different types of consumers—those who search extensively for a provider versus those who do not, or those who are deemed to be at special risk for exploitation versus those who are not. Finally, some studies have simply asked consumers or government contractors why they made the sectoral choices they did.

In my opinion the evidence supports the predictions of contract failure theory, but others have looked at the same studies and come to a different conclusion. In short, all evidence suggests contract failure exists and varies among various sectors of voluntary failure has not, to date, been well assessed, so the case for systematically preferring nonprofit providers is, at best, incomplete. 

Epithalories or disasters, they will have the capacity to treat everyone (Holmred 1983). Are uninsured hospital beds evidence of productive inefficiency, or of the efficient production of capacity insurance, an output excluded from empirical data? A related strand of literature argues that nonprofit inefficiencies are limited by competition with for-profit providers. Thus, for example, many studies (summarized in more detail in Steinberg 1987) compare the cost per claim processed by nonprofit and for-profit health insurance firms. The studies conclude that nonprofit plans operate at a cost disadvantage, so that the amount of providing affordable housing, assuming that nobody is denied medical care because of insufficient income, and the other sectors face. Nor do the studies recognize that the literatures has to a certain extent been built on misunderstanding this nonprofit role (e.g., Clifft 1992; Steisel and Weishoff 1998), but it rests well within, if not exclusively within, the economists' toolbox. Efficiency is defined with respect to preexisting consumer preferences. These preferences determine the value placed on various goods and services for use in determining the value-maximizing mix. Yet, the stated mission of many nonprofits is to change those preferences—to make people want to enjoy a habit of lifetime learning, to worship God, to preserve the environment, stop child abuse, or respect the decisions made by gun owners. Advertising, social marketing, and advocacy play a role in market efficiency, but I believe persuasion is informing those with preexisting preferences. Governments and for-profit also play roles in seeking to change preferences. Much more research is needed to understand the roles best played by each sector. Perhaps economists are not the best ones to conduct this sort of research, but the work that economists do should not blind us to the importance of these other roles.

Shortcomings of the Three-Failures Theory

Three-failures theory, at least in its exposition, is incomplete. The various pieces explain why consumers would want to buy from one type of provider but do not explain why nonprofit are there for them to choose from. It is needed in the theory of the supply of this organizational form to complement the theories of demand. Unless we know why and what nonprofit are using profits to make charities, it is hard to assess whether they can play the roles we have discussed. Predicting the objectives and behavior of individual organizations is also hard. How will they respond to changes in public policy, competition, the economy, or technology? Understanding the coexistence of providers from each sector is the same service industry is also difficult. If nonprofits are more motivated by resources than by history, why do they leave the market for these businesses outside of public policy, competition, the economy, or technology? Nonprofit production may play a role in the economic theories have more to say on the nature of the supply of services. If nonprofits are less efficient, then do they survive only because of subsidies? If they have complementary advantages, like a healthy lifestyle, and efficient disadvantage, is the nonprofit world better off? Is the non-profit market share entirely arbitrary or do economic theories have more to say on the market? For example, nonprofits produce a collective benefit that is typically omitted from empirical studies— the assurance that in cases of sudden increase in demand due to epidemics or disasters, they will have the capacity to treat everyone (Holmred 1983). Are uninsured hospital beds evidence of productive inefficiency, or of the efficient production of capacity insurance, an output excluded from empirical data?
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may care about the distribution of income, either directly or about changes in that distribution that they can take credit for (Steinberg and Weisbrod 2005).

The fifth category is income plus profits. This objective is used in the property rights literature (e.g., Frech 1976) but also appears in Preston 1988; Gunders 1989; Schiff and Weisbrod 1991; Eckel and Steinberg 1993; Steinberg and Eckel 1994 and Richardson 2000. By perquisites

result, I refer here to job attributes other than monetary compensation that are valued by the entrepreneur but not by others, including salaries, benefits, fancy offices, and on-the-job leisure. In a sense, the wages grow from providing public goods is also a perquisite. This job attribute the entrepreneur might value, but it also provides benefits to others, for example, Steinberg and Eckel (1994) call this a "public-

benefit perk."

The last category is a catchall, intended to remind us of all the benefits that economists typically leave out of their models. This includes desires for power, control, expression, affiliation, legitimation, and the like. Many entrepreneurial types listed in Young's (1988) original typology belong here, including "artists" (who value the creative act in reshuffling organizational blocks or creating a whole representing their vision), professionals (who value the pursuit and the direct impact), laymen (who seek the fruits of a takeover but limit such behaviors), and so on.

Nonprofit organizations are different. Nonprofits that want to provide collective goods are immune from takeover and any initial investment by the entrepreneurs is supplemented by the donations of others. This bit of foretelling suggests that we enumerate the factors that promote or hinder the entrepreneur's ability to accomplish his objectives through the nonprofit organizational form.

First, there are costs of entry (or of transforming the mission into an existing nonprofit). Ben-Net and Van Hoornissen (1999) detail these costs including: (a) obtaining the necessary bylaws and assembling a collection of willing stakeholders; (b) determining whether collective demand is sufficient to cover costs; (c) organizing the nonentrepreneurial decision and (d) incurring the costs of a governance mechanism to ensure stakeholder control against free-rider incentives.

Many existing models of nonprofit organizations postulate an entrepreneur who is hierarchically isolated from public officials and who is motivated by the existence of a private benefit. This model suggests an entrepreneur who does not care about the distribution of income, either directly or about changes in that distribution that they can take credit for (Steinberg and Weisbrod 2005). The fifth category is income plus profits. This objective is used in the property rights literature (e.g., Frech 1976) but also appears in Preston 1988; Gunders 1989; Schiff and Weisbrod 1991; Eckel and Steinberg 1993; Steinberg and Eckel 1994 and Richardson 2000. By perquisites, I refer here to job attributes other than monetary compensation that are valued by the entrepreneur but not by others, including salaries, benefits, fancy offices, and on-the-job leisure. In a sense, the wages grow from providing public goods is also a perquisite. This job attribute the entrepreneur might value, but it also provides benefits to others, for example, Steinberg and Eckel (1994) call this a "public-benefit perk."

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Many existing models of nonprofit organizations postulate an entrepreneur who is hierarchically isolated from public officials and who is motivated by the existence of a private benefit. This model suggests an entrepreneur who does not care about the
of governmental action: public arousal, information gathering, passage of laws, and establishment of a bureaucracy to control these laws. Most of the costs of founding a nonprofit are reduced if the founder is a member of a group of like-minded individuals who already work together with each other and so gain mutual trust. This happens through clubs, alumni groups, and most importantly religious congregations, so it is not surprising that religious nonprofits are excluded through a seed order advantage like a congregation. In contrast, the costs are increased if the pool of potential stakeholders is diverse. Although all might be high-downers, if they thoroughly disagree among themselves about what expenditure level on collective goods would be optimal, they might not agree to mutually form a new organization to meet their high demands. This suggests a revision of Weinberg's theory—preferences for the collective good must be heterogeneous (otherwise government suffers) but lumpy, with a cluster of agents who high-downers are willing and able to work together (Sten-Ner and Van Hoornisse, 1991).

Agency costs result whenever the entrepreneur (the principal) requires the assistance of others (agents) whose objectives are not thoroughly aligned with his own. The principal uses costly mechanisms that realign the agent's incentives (such as profit-sharing plans), monitors the performance of agents, and accepts that some failure will remain after incentives and monitoring are carried out. Agency costs are likely to differ with the prospective choices that an entrepreneur makes. Nonprofit plans are not necessarily restricted in the nonprofit sector by the nondistribution constraint, but to the extent nonprofit workers are motivated by accomplishment of the nonprofit mission, they receive a distribution in kind. A similar role (Svilińska, 2002; see also Brown and Svilińska, this volume, and Bijlöde and Steinberg, forthcoming).

One agency cost agency costs limit the duration of entrepreneurial control. Entrepreneurs can lose control during their lifetime if their for-profit firm is taken over, or if their nonprofit is sold to a larger nonprofit organization, and cannot lose control after their deaths. Closed corporations, with dynastic control, reduce this problem in the for-profit world, but for a strictly nonprofit purpose, an effective way to assure control of a nonprofit corporation is to provide a better solution. The availability of resources also determines entrepreneurial choice. In the for-profit sector, entrepreneurs can obtain capital by issuing shares of stock or obtaining loans. Nonprofits can do this only by disposal of land, and because any loans are not backed by a-risk shareholder investments, the cost of debt is higher than debt in the private sector (Hamermesh, 1985). However, nonprofits can use grants and donations, volunteer labor, and (depending upon local laws) tax-exempt bonds to obtain capital, and can accumulate retained earnings of a variety of ways more quickly if they are exempt from corporate income taxes. Resources from sales or from fundraising depend, in part, on competition from other organizations, that entrepreneurs would also consider the risk of potential competitors over the lifetime of their mission.

Finally, the way in which organizations in the various sectors are regulated, including the pace of enforcement of these regulations, determines the entrepreneurial objective can be best accomplished. We have already seen how these factors affect the single-nonprofit. The other way they matter are munitions and self-evident. The integrated approach advocate advocates that the entrepreneur picks the objectives for the organization. The social costs of this, that said, nonprofits arise in situ ations where it is very difficult to accomplish objectives using any kind of organization. The corresponding behavior and entrepreneurial objectives need not be very close, as entrepreneurs are hindered in this "least-worst" situation by transactions costs, agency costs, resource dependences, and governmental regulations that make it hard to transform objectives into results.

Fitting the Pieces Together

There are many ways to fit these various pieces together correctly and gain deep insight into the role of the nonprofit. The literature has only begun this process. Perhaps the best effort to date is found in a series of papers by Bijlöde and Sviłinska (1995, 1997, 1998) and by Bijlöde (2000), employing variations on a common framework. In all these models, a group of individuals cares about a collective good. Conquering the benefits of founding a new nonprofit to provide this good and carefully matching organizational structures to their needs is the objective of another member of the group, one of those choosers to be the entrepreneur. She invests an initial sum of money toward providing that good, and then asks for resources obtained from others, and then determines the total amount to the collective good. If the entrepreneur picks the nonprofit form, she is allowed to withdraw some of the initial investment after seeing how much other people want to invest, but if she picks the nonprofit form, any such withdrawal would violate the nonequilibrium constraint.

One puzzle for any nonprofit organization. For a non-profit founder who would consider all the factors at its disposal, the entrepreneur should consider the potential benefits of the nonprofit to achieve profits. Dividends can always be donated, and it would seem that the entrepreneur would like to choose a level of dividends that makes the collective good more sure to support the collective good. Bijlöde and Sviłinska provide an answer to this puzzle: other donors consider the entire sector in making their decisions. If they know that the entrepreneur could withdraw part or all of her initial investment in response to their donation, they would be reluctant to donate to an organization that might need the donations of others to accomplish their goal would want to give up the right to receive donations.15 The various papers by Bijlöde and Sviłinska extend this line of thought how nonprofits compete with each other or form a unitary union, how they compete in commercial markets also populated by for-profits, and how enforcement of the fair competition regulations.

Several papers tackle aspects of entrepreneurial sorting. In Bijlöde and Sviłinska (1996), potential entrepreneurs differ in entrepreneurial costs and the value they place on the collective good, but they focus on who emerges as a nonprofit founder without considering other entrepreneurial options across the sectors. Gaslier (1980) and Schiff and Weisbrod (1991) assume that entrepreneurs are of two types (those valuing only profits, and those valuing other things). These types sort perfectly across the for-profit and nonprofit sectors respectively. Steinberg and Eichfeld (1994) assume that potential entrepreneurs value three values: income, private benefit perks, and public-behavioral perks, varying in the relative importance of each. They show existence of two short-run effects of competition and tax policy (responsiveness to existing nonprofits and long-run effects due to a change in the type of entrepreneur who locates in each sector). It seems unclear at this stage how much their results will generalize.

Evidence

What evidence is available on the prevalence of various entrepreneurial and organizational objectives? One could simply ask these in control what they are trying to do, or collect and analyze organization mission statements. I am not aware of any studies that systematically survey founders, managers, or selected members of recognizable mission statements according to the set of objectives detailed above, and doing so would be worthwhile. How, this approach, either mission or nonprofit statements specific to for-profit organizations, often conflict, objectives without detailing how one objective is weighed against another. Mission statements are intentionally vague, as ten must specificity risks alienating selected groups of stakeholders. The stated mission of a nonprofit organization will sometimes differ from its real objectives.

Instead of surveying the stated objectives of organizations, researchers have analyzed nonprofit behaviors to detect the "revealed objectives" of the organization—those objectives which nonprofits are really trying to achieve. For example, Steinberg (1986) examines whether organizations act as if they want to maximize their net resources (defined as available resources minus fundraising costs) or their total budget (contribution) when they conduct fundraising campaigns. Service maximizers spend until the last dollar of fundraising expenditure brings in one dollar of added demands (with every previous dollar generating net resources), whereas budget maximizers spend until the last dollar brings in no additional demands. Steinberg finds that organizations act like service maximizers: "education," "arts," and "research" organizations spend less on fundraising than they would if they were service maximizers, and "health" organizations act like budget maximizers. Other studies using similar methods challenge his results and the question remains open.16

Since studies analyzing nonprofit patterns and drawbacks of the revealed objectives approach. Missions between stated and revealed objectives can be due to inaccurate information, data dependences or regulations that impose on behaviors, managerial errors or lack of knowledge, or the inability to control the actions of employees, subcontractors, and volunteers. For example, those in control of a network of organizations may have no intention of maximizing their budget, but may report that they appear to act like budget maximizers is important.

Lowry (1997) generalizes this approach to include the effects of other government policies and to broaden the class of objectives studied. He theorizes, like James (1983), that nonprofit managers have favored, neutral, and disfavoring objectives. Managers may care about revenues for their own sake (as in budget maximization), for their ability to support increased provision of favored activities, or both. He then analyzes a panel of community environmental groups and finds that they spend too little on fundraising (suggesting either that they are capital-constrained service maximizers or that they view fundraising as a dis-favored activity) and too much on collective goods (suggesting that the provision of collective goods is a favored activity) compared with the surplus-maximizing expenditure levels. He also finds that spending on collective goods and information (lossily, member benefits) is excess, suggesting that this too is a favored activity. A similar approach is taken by Vitaliano (2003), who compared religious nonprofit and secular nonprofits in the New York State. Twenty-one percent of these homes extended the quality and quantity of care beyond their estimated profit-maximizing level, suggesting the organizations acted as if they had quality and quantity objectives. The same study of each kind of organization departed from profit maximization. The remainder of the organizations acted like "for-profits-in-disguise," although Vitaliano concede this could be due to insufficient revenues to do anything else rather than duplicity.

Other papers infer the organizational objectives from the structure of managerial compensation. For example, Bullou and Weisbrod (2003) examine bonuses paid to hospital executives in for-profit and nonprofit hospitals. Controlling for many factors, they find that government hospitals are least likely to pay a bonus based on the quality of care, service maximization, what more likely, and religious nonprofits are much more likely to do so. They conclude that secular and religious nonprofit hospitals have different objectives, but that government hospitals are even more different. Whether the behavioral difference is due to objectives or constraints. Related studies (Robinson and Weisbrod 1999; Erm and Weisbrod 2002) confirm similar findings. Finally, Erm and Weisbrod et al. (2000) look at contractual bonuses given to university presidents when they meet academic, research, and administrative goals. A variety of other approaches for uncovering objectives have been tried. Eldenburg et al. (2004) examine the factors that determine the composition of hospital boards, board.
turnover, and CEO turnover to uncover objectives with respect to providing uncompensated care, generating excess revenues, and administrative costs. They find that for-profit, secular nonprofit, teaching, religious nonprofit, government, and district hospitals place different weightings on these three objectives. That said, uncovering the exact form of objectives from evidence of high turnover related to each of these factors. For instance, evidence of the response of hospital prices for private patients to changes in the Medicare, Medicaid, and charity clause. They find their profitability of the latter as objectives. Lastly, Kapoor and Weinberg (2000) examine whether government and private nonprofit nursing homes and facilities for the mentally handicapped differ in their use of waiting lists and consumer satisfaction levels. Finding significant differences, they note that one explanation is that government pursues a supplier-of-last-resort objective function.

IMPLICATIONS FOR PUBLIC POLICY

Economic theories about the role of the nonprofit sector have much to contribute to the public policy debates that swirl around the sector. Rather than treat any policy comprehensively (a task left to other chapters in this volume), I end this chapter by drawing the ways in which economic theory can be used here.

How should we design nonprofit cooperation statutes, and how should we further the nonnontiturn contiguous? The theory of contract failure suggests that our decisions here affect the trustworthiness of the sector, and this is one of the first published policy applications (Hammel 1981). From the trust perspective, the value of the nonprofit label applies equally well to purely commercial ventures as to traditional charities. Nonprofit policy also affects the ease with which nonprofits can obtain capital, and so interacts with the plethora of other statutes that exempt nonprofits from corporate taxation and allow them to benefit from tax-exempt bonds. The contract in which nondistribution is applied to all donors and takings affects the relationships with whom nonprofits can interact, and so interacts with the plethora of other statutes that exempt nonprofits from corporate taxation and allow them to benefit from tax-exempt bonds.

Should we exempt nonprofit organizations from income, sales, value-added, and property taxes? Exemption gives nonprofits more resources, but this is hardly the most efficient way to deal with market failures. Direct subsidies for providing collective goods can be offered to organizations in both sectors (as in the U.S. tax credit for historic preservation), or government can provide the collective good itself. Nonprofit exemption from the corporate income tax rewards organizations in proportion to their capital stock, exemption from sales or value-added tax rewards them in proportion to commercial activities, and exemption from property taxes rewards them in proportion to the value of their property.

None of these are particularly good at fostering the distinctive roles we have noted for the nonprofit sector.

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One, Atkinson and Stiglitz (1980 chapter 11) provide a limited introduction to the subtleties of this topic. Two, if there is no lock-in effect, this contract failure does not arise. For-profit firms solve the problem by offering money-back guarantees. Three, there are other causes of market failure (such as monopolies) that are not discussed here because nonprofits do not seem to play a role in coping with them. Darker and Gin (2003) provide an alternative but more comprehensive discussion of the demand for nonprofit organizations in situations of market failure. Four, to use Linial’s prices, the government must know each producer’s preferences. However, consumers might have an incentive to misrepresent their preferences to secure a lower price. Five, as argued below, the median producer voter’s incentive and the warm glow anomalia (Vines and Stiglitz (1980) is permanent, then governmental provision is efficient if only if the distribution of median-performed provision levels is symmetric about the mean.

Seven, some tax laws are poorly enforced so that payment of taxes is almost purely voluntary. Conversely, sometimes social pressures to make donations are so strong that payment is almost certain. Nonetheless it is sometimes impossible to view the nonprofit alternative as less coercive than governmental.

Contract failure is less important for certain types of voluntary or for the donations of money (e.g., Steinberg 1996). Volunteers observe and help decide how their labor is used, allowing them to obtain the incremental output they want. Thus, parents donate their time for profit day-care centers and children donate their time to for-profit hospitals and nursing homes to provide informal, educational, and social services that would otherwise be lacking.

Provision of parks is not, by itself, inefficient (Slocombe 1997). Nonprofit managers are often preoccupied with the mixture of mis-revenue and outputs; they have no desire to produce parks in any. The problem is really an allocative inefficiency, because (a) monopolistic competition necessarily leads to more of any service and the Implicit pricing that, to the nonprofit economist, is higher than the output earnings, whereas the for-profit manager wants revenue to a nonprofit but may enjoy otherwise lower costs because of its subsidies, these subsidies can be applied to park production. The higher social cost of nonprofit production is not due any grant in the public compensation or the profits necessary to affect the market produces a mixture that includes relatively too much high-cost nonprofit output and too low-cost social-good profit output. Nevertheless, because these inefficiencies show up higher cost, the literature has recently labeled this a form of productive inefficiency, a tradition we repeat here for consistency with the literature.

The solution to this problem lies in linking the three-the market failure mode. As a result, some received conclusions will change, but the three failures will remain a part of the story. Whether to call the result an enhanced three-failures theory or another name is entirely a matter of taste and semantics.

In private communication, Wolfgang Bialaschek suggested a further broadening of the modeling agenda, creating a "closed" theory that would embed economic theories within a world shaped by political, social, institutional, and cultural factors. Thus, both the preferences of entrepreneurs and the factors affecting their decisions would be determined by the social structure, networks, history, and the like. In turn, the behavior of nonprofit organizations at any point in time would help determine the future evolution of networks, government regulations, and even cultural norms. This approach would integrate the distributional, preference shaping, affiliative, and expressive roles of nonprofit organizations into the analysis. This approach would also help us understand the evolution of the roles played by the various sectors, and so seems well worthy of further development.

More precisely, Ben-Noe and Van Horn argue that a self-provision coalition is formed if the expected flow of net benefits exceeds the next best alternative. This coalition can take the form of forming a nonprofit or a nonprofit cooperative, with additional factors, skipped here governing that choice.

James (1982, 1986) observe that most secular nonprofits are formed out of such groups, especially religious congregations, but explains this as an attempt to gain converts. He notes that they are generally more successful in achieving this as a market.

More precisely, they show that the decision to incorporate as a nonprofit solves a social problem because the entrepreneur and other owners by acting as a commitment device in a three-stage game of perfect information. Donations still suffer from the free-rider problem, but they do not suffer from this problem of moral hazard.

Tichan and Chang (this volume) analyze selection and information issues to set what they reveal about nonprofit commercial activities. This is a start, but a more systematic and broad-ranging effort would be interesting.


18. I want to thank: I am unaware of any more economic arguments on either side of the tax exemption question, as well as the non-economic arguments. Personally, I am averse to exempting nonprofits from any kind of subsidy because I believe that the public operates at a higher level than nonprofit.

In this exercise, I am leaving out many more economic arguments on both sides of the tax exemption question, as well as the non-economic arguments. Personally, I am averse to exempting nonprofits from any kind of subsidy because I believe that the public operates at a higher level than nonprofit.
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