# 2 The Nonprofit Sector

Current interest in the private nonprofit sector of the American economy, by scholars and policymakers, has been stimulated by both the growing significance and the recent struggle of many organizations in this category.[1] The absolute size of the nonprofit sector only hints at its importance. Although sector definitions differ, there is agreement that the private nonprofit sector constitutes about 5 percent of overall economic activity, by various measures. Calculations by Ginsberg (1973) show that private nonprofits account for approximately 8 percent of employment and 5 percent of gross national product (GNP).[2] Tideman (1974), using a more restricted sector definition, estimates employment at 5 percent.[3] According to estimates made by Weisbrod, private nonprofit organizations, in particular, those designated as exempt from corporate taxes by the Internal Revenue Service (IRS), represented 5.2 percent of all corporations, partnerships, and proprietorships in the United States in 1979, received 3.5 percent of all revenue, and held 4.3 percent of the total assets of business firms in 1975-1976.[4] Other estimates of assets are higher.[5]

More important, however, the nonprofit sector is concentrated in such strategic areas as health, education, and social services (welfare), which together in 1976 represented 64 percent of all nonprofit revenue.[6] Nonprofits represent a major proportion of member institutions in such key service sectors as hospitals, residential facilities for the handicapped, disturbed, or dependent, museums, and colleges and universities. Furthermore, in the performing arts, religion, advocacy, and research, private nonprofits constitute significant, if not overwhelming, proportions of industrial activity.

Moreover, as Weisbrod and others have indicated, the nonprofit sector—specifically that part of the sector comprising organizations to which contributions are tax deductible—seems to be growing somewhat faster than the rest of the economy. Whereas the number of profit-making firms (proprietorships, partnerships, and corporations) increased roughly 3.3 percent per year in the early 1970s (1970-1975),[7] the number of nonprofit firms of tax-deductible status increased at a rate of 7.3 percent per year (1971 -1976).[8] Similarly, gross receipts of these two sectors exhibited annual rates of increase during the same periods of 15 percent versus 20 percent. Over a longer term, Hirstand reports that nonprofits' expenditures moved from 3 percent of GNP in 1960 to 5 percent in 1973,[9] and Clarkson indicates that the number of private, tax exempt organizations reported by the IRS more than tripled between 1965 and 1972.[10]

Nonetheless, amid this apparent prosperity there is serious worry about the future of many nonprofit organizations and the viability of the sector as a whole. The concern is especially acute in certain industries. For example, in higher education the Carnegie Council reports that one-quarter of private colleges are in trouble.[11] At a time when rates of failure among commercial business firms are declining[12], financial failures among organizations in a wide variety of areas—higher education, social service, the arts, even hospitals—are commonplace; indeed, proposals to merge and consolidate to preserve existing operations are almost routine. Furthermore, as government has come to finance a large proportion of the services delivered by nonprofit organizations, especially research, health care, social services, higher education, and the arts, serious concerns have arisen over the flexibility and vitality of this once truly independent sector. (See Rose-Ackerman and Nielson for a review of financing patterns.)[13]

If there is any agreement among observers on what is happening to the nonprofit sector, it is that this sector is changing. Agencies are dropping out, consolidation is taking place, finances are shifting, yet the number of new organizations is also growing, apparently faster than in the profit-making sector, and substantial numbers of innovative programs are developing. Charitable contributions are faltering as giving declines as a proportion of GNP,[14] but governmental financing and sales revenues have grown significantly.[15] By Weisbrod's calculation, volunteer labor devoted to nonprofit organizations has outpaced the general growth in the labor force in the 1960s and 1970s.[16]

If scholars are to understand the changing role of the nonprofit sector and the behavior of its member organizations and if policymakers are to deal intelligently with issues concerning the use and regulation of nonprofits for public purposes, then a more precise and robust knowledge base will ultimately be required—not just statistical information but a better conceptual frame of reference than is presently available. First, the nonprofit sector must be broken into its component parts and member organizations classified by their various types and purposes, because this sector seems much too diverse to be understood by a single characterization or model. Second, a theory must be developed for explaining the existence of nonprofits in terms of their special advantages and roles vis-a-vis governmental and profit-making organizations. Third, behavioral models must be synthesized to explain how nonprofit organizations decide on the nature, quantity, quality, costs, and other aspects of their services and operations. Despite the novelty of the study of nonprofits as an academic discipline and the enormity of the subject, scholars have already made important contributions to these classification, theory-building, and modeling tasks.

Classification of nonprofits must begin with a definition. What is a nonprofit organization? The basic answer, offered by Hansmann, is that an organization is nonprofit if it is prohibited by law from distributing surplus revenues (that is, receipts less expenditures, or profits) to individuals (owners).[17] This is the so-called nondistribution constraint, which requires that employees of a nonprofit organization receive reasonable salaries not directly determined by the organization's financial performance and that there be no owners or shareholders who receive dividends. As Hansmann is quick to indicate, nonprofit organizations may generate financial surpluses, but these must be retained or spent on activities consistent with the organization's purposes.

The nondistribution constraint is not very limiting in the kinds of organizations that it encompasses. For example, all organizations classified as exempt from corporate income tax by the IRS fit this definition. In particular, the IRS's Activity Code of Exempt Organizations, which, as Feigenbaum points out, serves a function similar to the Standard Industrial Code (SIC) for the profit-making sector, covers the following major functional categories: religious activities; schools and colleges, including research; cultural, historical, and other educational activities, including museums; other instruction and training activities; health services; business and professional organizations; farming and related activities; mutual organizations, including mutual insurance companies and savings banks and farmers' cooperatives; employee- or membership-benefit organizations, including labor unions and fraternal orders; sports, athletic, recreational, and social activities, such as country clubs; youth activities, such as Boy Scouts; conservation, environmental, and beautification activities; housing activities; inner-city or community activities; civil-rights activities; litigation and legal aid; legislative and political activities; advocacy; and additional categories that encompass counseling and assistance to needy individuals, community chests, cemeteries, emergency relief, and so on.[18] Such a bewildering array of activity in which tax-exempt nonprofits are involved makes classification all the more important. Nor, as Hansmann points out, is the IRS list of tax-exempt organizations a complete catalog of nonprofit activity.[19] Nonprofit laws of incorporation vary considerably by state. In some states with liberal incorporation laws a wide range of activities may take place in nonprofit form; in other states with more restrictive laws nonprofits are confined to more narrowly defined charitable and public purposes.

One way to classify nonprofits is to distinguish tax-exempt agencies to which charitable contributions are deductible from personal income taxes from those to which contributions are not deductible. The latter group consists of mutual-benefit organizations, such as farm bureaus, insurance agencies, unions, trade associations, and clubs that provide services and benefits only to their members. Tax-deductible organizations are assumed to serve a broader purpose, to which the general public may wish to contribute or from which it may receive benefits.

Hansmann takes a somewhat different angle in classifying nonprofits, noting that exemption by federal and state governments is somewhat arbitrary and irregular. He chooses to focus on more fundamental aspects of financing and managerial control.[20] In terms of financing, Hansmann differentiates donative from commercial nonprofits, the former being primarily dependent on charitable contributions for support and the latter depending mostly on revenues from sale of services to individuals or to governments via fee-for-service contracts. On the managerial dimension, Hansmann distinguishes mutual from entrepreneurial nonprofits, the former being controlled by patrons or members through a democratic process and the latter controlled by a self-perpetuating board of directors independent of the membership or clientele. Hansmann's classification is really a two-dimensional spectrum, because many nonprofits exhibit mixtures of contributory and sales financing and membership versus trustee control. Nonetheless, it is a useful classification for differentiating prominent varieties of nonprofit organizations in a rough way. For example, political lobby groups, such as Common Cause or college alumni associations, are mutual-donative nonprofits; country clubs or professional associations, for example, the American Economic Association, could be classified as mutual-commercial nonprofits; charities such as the Salvation Army, the Red Cross, or free museums are donative-entrepreneurial organizations; and hospitals, nursing homes, and research institutes are basically entrepreneurial-commercial in nature. Some nonprofits are harder to classify in terms of Hansmann's four-way scheme. Universities, for example, are financed by both tuition and contributions and are governed by trustees who are often elected from the ranks of alumni (who can be viewed as patrons or members).

There are, of course, many other dimensions along which nonprofit organizations can be differentiated. Nonprofit organizations vary tremendously in size, from those with annual operating budgets of $100,000 or less to those with annual budgets in the tens of millions of dollars. Another differentiating characteristic of nonprofits is the style and culture of an agency— for example, its orientation toward business management and efficiency or toward professional disciplinary interests and research and toward self-determination versus orientation to a larger system or network of agencies.[21] As indicated by Sarason,[22] Lehman,[23] and others, the presence of networking is a significant phenomenon in the nonprofit social and health services. One important facilitator of such a network orientation is the affiliation of organizations with charitable or planning systems, such as The United Fund or health and welfare councils. A particularly important affiliation in some areas—especially in social services, health, and education—is the connection to a religious system, for example, the Catholic Charities or the Federation of Jewish Philanthropies. In a number of the author's case studies membership or lack of membership in a federation is seen to significantly influence organizational behavior.

Within this taxonomic state of understanding of nonprofit organizations it is possible to focus on particular varieties for more intensive study. My concern here is with entrepreneurial, commercially oriented nonprofits, because these are the nonprofit agencies primarily engaged in public-service delivery. Variations in the sources of financing and control will be of special interest. Concentration will also center on "deductible" organizations, which are generally formed with some element of public purpose in order to solicit private donations. Attention is not confined to agencies of a particular size, style, or affiliation, however. My interest is to reflect broadly on the activity of nonprofits in the delivery of general public services in areas such as social welfare, health, education, research, and the arts, where, conceivably, services may be carried out through the public or profit-seeking sectors as well. In this manner, I hope to be able to highlight the process of sector choice as well as the behavioral implications of the nonprofit alternative.

The theory explaining the existence of, or rationale for, nonprofit organizations has various strands. Contributions by Weisbrod and Hansmann are some of the most notable to date. Weisbrod essentially asserts that nonprofit organizations have arisen as a consequence of unsatisfied demands for public goods.[24] This is a kind of government-failure argument, wherein the public sector is seen as unable to satisfy the demands of some groups who desire a greater quality or quantity of some public services. Hence these groups organize on a voluntary basis to satisfy the collective demand neglected by the government. The large group of donative organizations supported by charitable contributions for which there is no direct *quid pro quo* would seem to offer services with a strong public-goods character. Commercial nonprofits of the mutual variety, supported by membership contributions, also appear to provide collective goods for their admittedly limited publics, and those of the entrepreneurial variety are often financed by public fee-for-service funds and hence are agents if not architects of public purpose.

Hansmann comes to his explanation of nonprofits from the opposite direction of market failure,[25] basing his analysis on earlier work of Nelson and Krashinsky in the area of day care for young children.[26] Hansmann argues that nonprofits arise in areas of activity where the consumer is disadvantaged in his ability to discern or evaluate the quality of services. In essence, Hansmann observes that nonprofits are viewed as more trustworthy by the consumer because of the presence of the nondistribution constraint, which reduces the probability that management will make sacrifices in the quality of services to increase financial returns. Thus nonprofits arise in such areas as nursing homes, child care, hospitals, education, and research either because consumers (children, the sick, and so on) are incompetent judges or because the services involved are too complex for the layman to evaluate.

An alternative way of characterizing the trustworthiness argument is to view the problem as an asymmetry of information between producers and consumers.[27] Michelle White uses this perspective to explain why profit-making, nonprofit, and governmental suppliers are observed to exist simultaneously in a given area of service, such as day care or nursing care.[28] White argues that consumers, or consumer agents, for example, parents, make trade-offs between having to spend time monitoring inherently less trustworthy profit-making suppliers and using the less market-responsive (but more trustworthy) services of nonprofits or governments. Trustworthiness is seen to increase, and hence monitoring costs to decrease, as one moves from profit-making to nonprofit to public suppliers, whereas responsiveness to consumer preferences, that is, provision of desired price-quality combinations, is seen to vary in the reverse direction. Thus the marginal value of a person's time, that is the time available for personally monitoring service quality, determines his sectoral selection of suppliers. This value of time can be expected to vary by income and other variables, hence organizations in each sector can be presumed to attract different classes of consumers.

There is an interesting closure between the public-goods and trust rationales for nonprofits, posed recently by Weisbrod.[29] In particular, Weisbrod observes a growing public demand for trustworthy institutions as goods and services become more technologically complex over time (such as medical care, energy production, food additives, legal liabilities, and so on). Hence he speculates that the growth of nonprofits is a response to this demand.

Since de Tocqueville's time, the vitality of the American democracy and economy has been seen to lie in the diversity of its economic and political system, owing in part to the ability of citizens to organize themselves on a private, voluntary basis. Thus a traditional argument for nonprofit activity is its character of public-spirited action, independent of government, decentralized and flexible, yet still community-oriented in nature. As explained by Douglas, the nonprofit sector is able to serve this function because it is free of the categorical constraint that requires government to provide its services on a fairly equal basis to all citizens:

> The extent to which the categorical constraint will limit the freedom and constrain the flexibility of the public sector will vary . . . somewhat according to the system of government. . . .Yet there must be a limit to the extent to which the law can bend . . . if the principle of equality before the law is not to be broached. . . .The private non-profit sector has something of the same flexibility of the market sector, but . . . can apply its flexibility to public goods. . . .[T]he government sector has

> the . . . drawback that it is unable to allow citizens to opt out and must therefore either perpetrate the injustice of compelling citizens to contribute to a service of which they disapprove, or . . . fail to produce a service needed by [some] . . . deserving groups.[30]

The rationale of independent and diverse public-oriented provision certainly appears to underlie the justification for political lobbying organizations, charities, and other activities that Hansmann might classify as mutual or donative nonprofits. It would also seem to apply to entrepreneurial-commercial nonprofits in such service-producing activities as child care, hospitals, museums, and schools, where the presence of nonprofits serves as a counterweight to potentially more monolithic governmental or profit-seeking domination and as an independent source of innovation, treatment methodology, and policy concepts.

Several scholars have postulated positive models of the behavior of nonprofit organizations. Interestingly there is not a particularly good fit between the conceptual rationale for nonprofits as providers of public goods and as fiduciaries for troubled consumers and the stipulated behavioral propensities postulated in existing economic models. Niskanen, for example, describes the nonprofit organization as a revenue-maximizing entity from which agency management derives personal utility from power, prestige, monetary benefits, and so on.[31] Tullock provides a parallel model for charities,[32] and Pauly and Redisch view the nonprofit hospital as a device for maximizing physicians' incomes.[33] Etzioni and Doty also take special note of income-increasing tendencies within nonprofits.[34] Feigenbaum, following the managerial-discretion approach of Williamson[35] and Migue and Belanger,[36] postulates that nonprofits will, in effect, maximize profits (surpluses of revenues over minimizing costs), which are then used for both demand stimulation and managerial reward.[37]

James models the nonprofit university as a source of utility for faculty.[38] In this model, revenues from undergraduate teaching are seen to subsidize the research and graduate-school activities that the faculty prefer. Alternatively, Newhouse characterizes the hospital as an output-maximizing agent, subject to physicians' choices of appropriate quality of services.[39] Carlson follows a similar approach.[40] Clarkson provides a catalog of such economic models for describing nonprofit and other types of firms.[41]

The chasm that separates the rather noble-purposed explanations of nonprofit activity from the skeptical, almost cynical assumptions of the positive-modeling approaches can be bridged by one view of nonprofit development: nonprofits are formed and authorized in response to particular public needs—the provision of certain public goods and the delivery of certain services that require a fiduciary relationship with the consumer. Certain legal requirements are imposed and privileges granted to nonprofits, most notably the nondistribution constraint and tax relief, to encourage compliance with the intended purposes. However nonprofit actors (management) ultimately attempt to test these constraints and manipulate them toward selfish ends. In so doing they may be more successful than their more idealistic colleagues in ensuring their own survival. Hence the noble-purposed nonprofit becomes a means to selfish ends.

Such a view is characteristic of the assume-the-worst, homogeneous maximizing school of economic modeling, which has enjoyed success in application to the profit-seeking sector (for example, the assumption that all managers maximize profits) and some success with respect to the public-sector, for example, the budget-maximizing models.[42] Recently, however, the more simplistic homogeneous models have been called into question. In the corporate, profit-making sector, for example, it has been recognized that the separation of ownership from managerial control undermines the assumption of profit maximization. Managers often have the opportunity to indulge in individual expense-preference behavior, some of which might be community minded, professionally oriented, or otherwise nonpecuniary in purpose.[43] In the public sector, in the current era of tax-limiting fervor, simplistic assumptions about budget maximizing will have to be reconsidered as bureaucrats and politicians find rewards for cost cutting as well as for program expansion.

In the nonprofit sector, some models have recognized benevolent or nonpecuniary motivations associated with nonprofit activity. Both Weisbrod and Hansmann have considered the differential motives that draw employees and managers to the nonprofit sector. Hansmann postulates two types of managers—those solely interested in pecuniary gain and those also interested in managing institutions of high quality. He shows that the reduced monetary reward offered by nonprofits acts as a signaling device to attract quality-oriented managers and, as a result, nonprofits will produce outputs of higher quality.[44] Weisbrod follows a similar line in his analysis of the employment choices of law-school graduates.[45] Differentiating between those graduates primarily interested in money and those interested in public-interest legal work, Weisbrod finds that graduates who join public-interest firms accept significant pay reductions relative to graduates with equivalent credentials who work for profit-making law firms.

The works of Hansmann and Weisbrod in the nonprofit sector and work by Tullock[46] and others (Daly)[47] in the public sector emphasize the process of screening in the labor market as the salient mechanism through which different sectors of the economy acquire their motivational characters. Screening or self-selection occurs on the basis of differences in structural variables among sectors (supply-side aspects, as Daly calls them), such as income potential and intrinsic character of the work to be performed. The differential filtering of motivation into sectors that allow room for managerial discretion determines the ultimate behavior of firms. Thus, for nonprofits, according to Hansmann's and Weisbrod's analyses, the screening process may be expected to produce organizational activity that is less tuned to pecuniary aggrandizement than that of firms in the profit-making part of the economy.

Because of the nonprofit sector's size and diversity, full clarification of the behaviors of nonprofit organizations will require extensive work by researchers. The screening approach articulated by Hansmann and Weisbrod, particularly if coupled with empirical investigation, seems likely to be one of the more fruitful strategies for several reasons. First, this approach recognizes that the nonprofit sector exists not in isolation, but in conjunction with other sectors, in most fields of activity. Second, the screening approach acknowledges seemingly obvious differences in motivations among participants within any given field of economic or social endeavor and the common existence of maneuvering room to indulge these motivations. Third, the screening approach postulates that differences in the character of nonprofits versus other forms may appeal to people with certain motivations more than to others. Thus the structural characteristics and opportunities for managerial discretion offered by nonprofits interact with the pool of motivations of potential participants to produce behaviors that distinguish this sector from others. Furthermore, such results may be expected to vary by field or industry, as the motivations of potential entrants and the structural characteristics also vary among industries.

In this book, the idea of screening is used to help explain the differential behavior of organizations in the nonprofit sector by focusing on a particular class of participants—the *entrepreneurs* who mobilize people and resources required to establish new organizations or implement major new programs or policies. In this way I intend to illuminate the reasons that economic activity takes place and that particular types of entrepreneurs participate in the nonprofit sector, and to discern the behavioral tendencies of nonprofits that derive from this selection process. That effort begins with a discussion of entrepreneurship in the next chapter.

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