View metadata, citation and similar papers at core.ac.uk

brought to you by CORE

provided by University of Chicago Law School: Chicago Unbound

University of Chicago Law School
Chicago Unbound

Coase-Sandor Working Paper Series in Law and Economics

Coase-Sandor Institute for Law and Economics

2006

The Case for For-Profit Charities

Eric A. Posner

Anup Malani

Follow this and additional works at: https://chicagounbound.uchicago.edu/law_and_economics

Part of the Law Commons

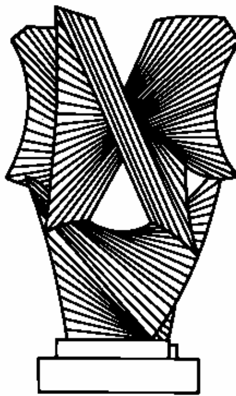
Recommended Citation

Eric Posner & Anup Malani, "The Case for For-Profit Charities" (John M. Olin Program in Law and Economics Working Paper No. 304, 2006).

This Working Paper is brought to you for free and open access by the Coase-Sandor Institute for Law and Economics at Chicago Unbound. It has been accepted for inclusion in Coase-Sandor Working Paper Series in Law and Economics by an authorized administrator of Chicago Unbound. For more information, please contact unbound@law.uchicago.edu.

CHICAGO

JOHN M. OLIN LAW & ECONOMICS WORKING PAPER NO. 304
(2D SERIES)



The Case for For-Profit Charities

Anup Malani and Eric A. Posner

THE LAW SCHOOL
THE UNIVERSITY OF CHICAGO

September 2006

This paper can be downloaded without charge at:
The Chicago Working Paper Series Index: http://www.law.uchicago.edu/Lawecon/index.html
and at the Social Science Research Network Electronic Paper Collection:
http://ssrn.com/abstract_id=928976

The Case for For-Profit Charities

Anup Malani[1] and Eric A. Posner[2]

September 4, 2006

Abstract. Nonprofit firms may not distribute profits to owners but instead must retain them or reinvest them. Nonprofits that are "charitable organizations" under § 501(c)(3) of the tax code may receive donations from individuals who are allowed to deduct their donations from their income for tax purposes. We argue that the law should not link tax benefits to corporate form in this way. There may be good arguments for recognizing the nonprofit form and good arguments for providing tax subsidies to charities or donors to charities, but there is no good argument for making those tax subsidies available only to charities that adopt the nonprofit form. Consequently, the "for-profit charity" may well be a desirable institution. Currently, no such entity exists, but the reason is surely discriminatory tax treatment; the charitable activities of many commercial firms suggest that in the absence of discriminatory tax treatment for-profit charities would flourish. Current tax benefits for charitable nonprofits should be extended to for-profit charities, and to the charitable activities of for-profit commercial firms.

I. Introduction

Not-for-profit (NFP) firms are firms that cannot distribute their profits to any affiliated persons or employees (a restriction known as the "nondistribution constraint"). Charitable NFPs are NFPs that primarily engage in one of the activities set forth in §501(c)(3) of the tax code, among them charity.[3] All NFPs receive preferential tax treatment relative to the for-profit (FP) firm with respect to income, retained earnings, bond financing, sales, and property ownership. Charitable NFPs also enjoy a further benefit: their donors are permitted to deduct their donations from their income for tax purposes. Because donors have this tax benefit, they will donate more than they would otherwise, and only charitable NFPs can be the beneficiaries of these donations.

The literature contains three explanations for why the NFP form is recognized by the law and why charitable NFPs receive these tax benefits. The *public goods theory* holds that the charitable benefit encourages people to donate to firms that create public goods and this is more efficient than direct government production of public goods through the funding of projects from general tax revenues. The *agency theory* holds that the NFP form solves a problem of asymmetric information that arises when consumers

---

[1] Professor, University of Chicago Law School.
[2] Kirkland & Ellis Professor, University of Chicago Law School. Thanks to Henry Hansmann, Louis Kaplow, Saul Levmore, David Weisbach, an audience at the University of Virginia Law School, and participants at a panel at the American Law and Economics Association annual meeting, 2006, for helpful comments. Thanks also to Eric Wood for research assistance.
[3] I.R.C. § 501(c)(3) (2006).

cannot adequately evaluate the quality of goods they would like to buy or the activities of a charity to which they would like to donate. The NFP form protects these consumers from being taken advantage of by profit-seeking producers. Finally, the *altruism theory* holds that the NFP form attracts owners who care not just about profit, but also about the quality or quantity of production. If an owner cares only about profits, she will not be attracted to the NFP form because it will not allow her to cash out the firm's profits. The NFP form thus encourages altruists to undertake activities that will benefit others.

We will argue that none of these theories answers what we will call the *coupling* or *linkage* question, that is, why a particular tax benefit (for example, the deduction for charitable donations) is conditioned on a particular corporate form (the NFP form). The public goods theory explains why the government should use tax subsidies or other benefits to encourage charitable activity but cannot explain why the government should not use such benefits to encourage charitable activity undertaken by FP firms. The agency theory explains why people might prefer to purchase from, or donate to, the NFP firm, but not why NFP firms should receive a tax benefit. The altruism theory explains why coupling tax benefits to NFP status transfers wealth to altruists, but not why that is a good idea.

Because none of these theories justifies coupling the NFP form and tax subsidization, coupling should be eliminated. Eliminating coupling would enhance efficiency in several ways. It would encourage charitable entrepreneurs to choose among corporate forms on the basis of their efficiency properties rather than their tax advantages. And it would allow commercial firms to more easily exploit economies of scope in providing commercial and charitable services. We predict that the eliminating of coupling would lead altruistic entrepreneurs to create FP charities, which would, in a range of circumstances, be more efficient than both NFP charities and the existing charitable arms of many FP firms.

Our paper is related to an earlier debate about whether or not *NFP firms* should be taxed like FP firms when NFP firms engage in *commercial* activities. For example, a museum has NFP status but its gift shop engages in commercial activities. The federal government's current approach is to tax NFPs the same as FPs when NFPs engage in commercial activities. Thus, the museum does not pay taxes on its profits but the gift shop does prior to funneling its profits to the museum, which can then use them for educational activities. This is implemented via the so-called unrelated business income tax (UBIT) on NFPs;[4] the purpose of the tax is to deprive NFPs of tax advantages when NFPs compete against FP firms in commercial markets.[5] The issue we raise is the flipside of the UBIT debate: should *FP firms* be taxed like NFP firms (or more precisely, exempt from taxes like NFP firms) when they engage in *charitable* activities? Our answer is: yes, because there is no reason to condition the tax subsidy for charitable activities on organizational form.

[4] I.R.C. § 512(a) (2006).

[5] *See* Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VA. L. REV. 605, 606 (1989); Charles T. Clotfelter, *Tax-Induced Distortions in the Voluntary Sector*, 39 CASE W. RES. L. REV. 665, 678 n. 7 (1989).

This paper is organized as follows. Part II provides background on NFP law and the organization of NFP firms. Part III discusses the theories that support coupling and advances our critique of those theories. Part IV addresses some objections to decoupling. Part V discusses the important case of "mixed charities," often discussed under the rubric of corporate responsibility. We conclude with a proposal for reform.

II. Background

A. Legal Treatment of Non-Profit Firms

The laws of every state recognize that a firm may either have FP or NFP status. A FP firm may pay its profits to the owner(s) of the firm. The key constraint on a NFP firm is that it may not pay its profits to the owner(s) of the firm. Instead, the NFP must retain its profits or spend excess revenues on its business (in which case it does not have profits). Suppose that an entrepreneur sets up a firm. If the firm is FP, the entrepreneur, as the sole owner, retains all profits. If the firm is NFP, the entrepreneur may not retain the profits, though she may pay herself a wage. The wage may not be a proxy for profits (for example, bonuses when profits are high); it must be relatively fixed, and keyed to the market, so that the entrepreneur earns about the same as an employee would be paid for similar services. For example, the entrepreneur who manages a NFP may pay herself a salary equal to the salary received by the manager of a comparable commercial firm.

Some states limit the scope of business of NFPs, but as a general proposition they permit FP firms to compete in the same market as NFPs. Thus, we observe FP and NFP hospitals, FP and NFP daycare centers, FP and NFP publishers, and so forth. Federal law recognizes NFP status and affords NFP firms certain benefits so long as they do not have a commercial purpose. Specifically, under §501(c)(3) of the tax code, NFPs may obtain tax breaks so long as they engage in charitable, education, scientific, or artistic activities.

The most visible federal tax benefit for NFP firms that have §501(c)(3) status is their freedom from corporate income taxation. But this is actually not much of a benefit. FP firms do not pay corporate income taxes if they, like an NFP, have no profits. Moreover, under certain conditions – not having more than 100 shareholders and not being traded on a stock exchange – the IRS permits FP firms to elect "pass-through" treatment and avoid corporate income taxes.[6] The main tax advantage enjoyed by the

[6] I.R.C. §§ 1361-1379 (2006). A NFP can earn profits, but cannot distribute them. If a FP makes profits, it has three options. (1) Pay corporate income taxes on the profits and distribute the after-tax profits to owners, who then have to pay personal income taxes on the distribution. (2) Pay corporate income taxes on the profits and retain the earnings until the next year. (3) If it is permitted to choose pass-through treatment, its shareholders would have to pay personal income tax on the profits of the firm, whether the firm distributed profits to its shareholders or retained the earning. In other words, whereas the NFP firm can retain its profits in a liquid form from year-to-year, a FP cannot do this without either paying corporate income taxes or personal income taxes. (In the latter case, the shareholders can make a capital contribution to the firm the next year and that would serve the same purpose as retained earnings.) Offsetting the

non-commercial NFPs is rather the right of donors to deduct their donations from their income for personal income tax purposes. Beyond these federal tax benefits, NFPs of all types also enjoy various state law tax advantages, such as exemption from sales taxes.[7]

As our discussion has made clear, the federal and state tax codes *couple* NFP status and the tax subsidy. A charitable firm that is FP does not enjoy the tax subsidy. This question is, What is the justification for coupling?

B. The Structure of the NFP Sector

There are three basic characters in any firm: the entrepreneur, the consumer, and the beneficiary. The entrepreneur sets up the firm. In some of our discussions below, the entrepreneur may also manage the firm and (if the firm is for-profit) own shares in it. If the firm produces ordinary goods or services (medicines, entertainment, etc.), the consumer purchases these products; the consumer is the same as the beneficiary. If the firm is a charity that provides money or some other benefits to others, the consumer is the donor; the beneficiaries are those who receive cash or services from the firm.[8] The non-charity and the charity settings have slight differences – the charity case has an extra character, the beneficiary – but these differences are mostly of no importance for our argument; when they are, we will say so.

The features that distinguish a NFP and a FP firm are complex. We'll describe them, and then summarize them in Table 1 so that they are easier to recall. A NFP firm may be a charity or a non-charity. However, the NFP firm is confined to producing only certain non-charitable products, such as healthcare and education.[9] A FP firm may also be a charity or a non-charity. There is no restriction, however, on the non-charitable items it can produce. We shall distinguish the non-charitable goods that only FP firms may produce by labeling them commercial products.

A NFP obtains favorable tax treatment for charitable activities and for non-commercial non-charitable activities. In practice, however, donations, and thus the

---

advantage that NFP firms can retain earnings without paying any tax is that NFP firms cannot distribute profits to shareholders.

[7] They also cannot be subject to an involuntary bankruptcy petition under §303 of the Bankruptcy Code (11 U.S.C. §303 (2006); seem to be preferred when governments contract out functions (consider the relative enthusiasm about NFP charter schools, compared to the uneasiness about for-profit schools; *see e.g.*, John Morely, Note, *For-profit and Nonprofit Charter Schools: An Agency Costs Approach*, 115 YALE L.J. 1782, 1800-1805 (2006))); and enjoy other advantages.

[8] To be clear, we call a firm a charity only if consumers/donors benefit *only* through the consumption of beneficiaries. So, for example, an opera is not a charity. A donor to the opera may intend both that others benefit from her contributions to the opera and that she benefit directly by attending performances. Thus, whether a NFP receives donations does not exclusively determine whether it is a charity in our typology.

[9] This is a product of state laws that authorize the formation of NFP firms. *See, e.g.,* Indiana Nonprofit Corporation Act of 1991, IND. CODE ANN. § 23-17-1 (Burns Supp. 2006); Montana Nonprofit Corporation Act, MONT. CODES ANN. § 32-2-113 (2005). In addition, § 501(c)(3) of federal tax law only extends breaks to NFP firms that engage in, for example, "religious, charitable, scientific, … literary, or educational" activities.

preferential tax treatment for donations to a NFP firm, are concentrated among charitable NFPs. For example, while it is possible for NFP hospitals to receive donations, donations typically comprise a tiny fraction of a NFP hospital's revenues.[10] By contrast, donations are a large portion of the revenues of charitable NFPs such as United Way.

Also in practice, NFP and FP firms compete head-to-head mainly in non-commercial, non-charitable markets. There are no FP firms in charitable markets. (FP firms may make charitable contributions, but they do not channel third-party donations to beneficiaries.) Moreover, NFPs generally do not compete directly with FPs in commercial, non-charitable markets. There is some incidental competition here, as when a NFP hospital operates a gift shop or a NFP university operates a bookstore. But those activities are limited, in part because such activities are subject to the unrelated business income tax (UBIT), which, as we noted above, is meant to level the playing field between NFP and FP firms in commercial markets. In non-commercial, non-charitable markets, however, there is generally non-trivial and direct competition among NFPs and FPs, a condition that is also called "mixed-production" in the academic literature on non-profits.[11]

Table 1. Distinguishing features of NFP firms.

	Charitable market	Non-commercial, non-charitable market	Commercial, non-charitable market
Examples	Churches, medical charities, United Way, Red Cross, Sierra Club	Healthcare facilities, childcare facilities, schools	Retail sales, car manufacturing, pharmaceuticals
NFP presence?	Yes	Yes	Incidental
Tax breaks for NFPs?	Yes	Yes	No (UBIT)
Donations?	Yes	Generally, no	No
FP presence?	No	Generally, yes	Yes
Tax break for FPs?	No	No	No

C. Model of Non-Profit and For-Profit Charity

The remainder of the paper focuses on the bottom two cells of the second (charitable market) column of Table 1; for clarity, they are shaded.[12] Given this schematic, the question we posed at the end of Section II.A can be rephrased: why should FPs not be given the same tax breaks as NFPs are for charitable activities? In order to answer the question, it is useful to have an example of a hypothetical charity and see how operations and incentives differ depending on its organizational form. Suppose a consumer/donor wants to send money to a beneficiary such as sick children in Africa. A charity entrepreneur using her organizational skills and contacts offers to facilitate this transfer. She forms a NFP firm and promises that, if the donor gives her $100, she will

[10] The notable exception to this tendency is higher education. Universities produce a non-charitable product, but receive large amounts of donations.
[11] *See* Darius Lakdawalla & Tomas Philipson, *Nonprofit Production and Competition* 4 (Nat'l Bureau of Econ. Research, Working Paper No. 6377, 1998).
[12] The literature on the UBIT referenced in the introduction focuses on the fourth (tax breaks for NFPs) cell of the fourth (commercial, non-charitable market) column; it is also shaded.

ensure $80 reaches the hands of the sick children. The rest will be used to pay administrative costs. Specifically, she will take a salary of $10 and use $10 for other expenses.

What would happen if the entrepreneur, instead of taking the NFP form, chose the FP form? First consider what would not change. She could continue to adhere to her promise to send 80% of the donation to sick children. She could spend $10 on administrative expenses. Whether the entrepreneur chooses a FP form that enjoyed pass-through tax treatment or not, she could also continue to enjoy a $10 salary because her salary is tax deductible for the firm. In other words, after she received $100 from the donor, she could run her charity the exact same way she did before she took the FP form.

Now consider what would change if the entrepreneur took the FP form. First, the donor would have less incentive to send money to sick children in Africa through the entrepreneur's FP firm. If the charity entrepreneur took the NFP form, the donor could deduct his donation from his total income when calculating his taxable income (assuming the donor itemized his deductions) for personal income tax purposes. Once the charity becomes FP, the donation is no longer deductible. In other words, while one can donate to NFP charities using pre-tax dollars, one can only donate to FP charities using after-tax dollars. The subsidy for donation to NFPs is equivalent to the donor's personal income tax rate.

Second, the entrepreneur would have greater incentive to make the charity more efficient by lowering administrative costs.[13] Suppose the entrepreneur, by careful planning, could reduce expenses other than her salary from $10 to $8. If the charity were FP, she could pocket some of the extra $2 as profit. (If the FP firm qualifies for pass-through tax treatment, then she could keep all $2.[14]) But if the charity were NFP, she would have to leave the $2 in the firm because the NFP form does not permit distribution of profits. This reduces the entrepreneur's incentive to keep expenses down.

Table 2. Model of NFP and FP charities.

	NFP charity	FP charity	FP (after reduction of admin. expenses)
Contribution by donor (Pre-tax dollars)	$100	$150 (33% tax rate)	$150 (33% tax rate)
Money for beneficiary	$80	$80	$80
Admin. expenses (other than entrepreneur salary)	$10	$10	$8
Entrepreneur's salary	$10	$10	$10
Profits distributed to entrepreneur			Up to $2

[13] *See* Armen Alchian & Harold Demsetz, *Production, Information Costs and Economic Organization*, 62 AM. ECON. REV. 777, 790 (1972); H.E. Frech III, *The Property Rights Theory of the Firm: Empirical Results from a Natural Experiment*, 84(1) J. POL. ECON. 143, 144 (1976) (noting this is natural consequence of the manager's attenuated property rights in the firm's profits).

[14] See text accompanying note 6.

This simple model of NFP and FP charities – summarized in Table 2 – illustrates our basic hypothesis. As Table 2 shows, the donor must effectively pay more in order to have the same charitable effect if the charity is FP than if the charity is NFP. This is why there are currently no FP charities. The FP charity, however, could be more efficient – in the sense that its administrative costs are lower because the entrepreneur has stronger incentives to minimize administrative costs (compare column 4 to column 3). We will return to this model in the next section in order to illustrate how the major theories that explain the NFP form fit into our analysis.

III. A Critique of Coupling

In this section, we critique the major theories (the public goods theory, the agency theory, and the altruism theory) that might be offered to explain coupling. Our critique shows that there is no good reason for conditioning tax subsidies on nonprofit status. Thus, we argue affirmatively for decoupling: The tax system should not be used to encourage charity-minded entrepreneurs to prefer the NFP form over the FP form. Tax subsidies should be based entirely on the social value of the activities of a firm, whatever its corporate form.

A. The Public Goods Theory

An old but still prominent view is that the reason the government does and should subsidize NFPs is that NFPs produce public goods.[15] Consider, for example, a NFP that takes donations and uses the money to clean up a park. Suppose that locals care about the park. In the absence of the NFP, people are unlikely to invest the optimal amount to clean up the park. The reason is that although every person benefits from a clean park, one benefits even more if everyone else does the cleaning. If everyone thinks in the same way and free rides on the clean-up efforts of others, the aggregate investment will be less than what is optimal.

The standard solution to this problem is government action. The government taxes everyone and then uses the money to clean up the park. However, a problem with this type of intervention is that the government may have difficulty determining the preferences of citizens. If citizens care about the park a little, the government should invest little in maintaining it; if citizens care about the park a lot, the government should invest a lot. But determining and aggregating preferences is difficult, so the government may end up supplying too little or too much maintenance.

An alternative approach, one that relies on less intrusive government regulation, is tax subsidies for NFPs. The NFP takes donations, and because donors receive a tax benefit, they donate more than they would otherwise. At the same time, donation remains

[15] *See* BURTON A. WEISBROD, THE NONPROFIT ECONOMY 59-60 (1987); Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J., 835, 848 (1980); Henry B. Hansmann, *Economic Theories of Nonprofit Organizations*, in THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 27, 29 (W. Powell ed., 1987).

voluntary, so people will donate only if they have a relatively strong preference for the collective good supplied by the NFP. Thus, greater donation will occur than in the absence of the tax subsidy; and the donation will reflect preferences better than government intervention does. This does not mean that the free riding problem is solved. Some people who benefit from the park will decline to donate even with the tax break. But the free riding problem should be reduced.

We take no position on whether this story is correct, although we will assume that it is correct for purposes of our argument. If it is correct, the theory does justify tax subsidies for activities that benefit others. However, the crucial point is that the theory does not justify tax subsidies for NFPs only. They should be given to any firm – FP or NFP – that engages in activities that benefit third parties. Indeed, we do observe government giving tax subsidies to FP firms. Consider massive subsidies to alternative energy producers, for example – including to automobile manufacturers that develop hybrids and farmers who develop ethanol-based fuel.[16] Similarly, the public goods theory we have described cannot explain why the government should give tax subsidies to donors who contribute to a NFP park clean-up firm, but not to donors who contribute to a FP park clean-up firm. Indeed, the public goods theory justifies subsidies (tax or otherwise) to park clean-up firms, whether FP or NFP, that do not take donations but charge fees. In sum, the public good theory justifies tax subsidies but does not justify the coupling of tax subsidies and the NFP form.

B. The Agency Theory

Recall the three characters in a charitable firm: the entrepreneur, the consumer, and the beneficiary. The consumer is the donor, he gives money to the entrepreneur, and the entrepreneur conveys it to the beneficiary. According to the agency theory, the entrepreneur cares about two things: her own income and benefiting a third party such as a poor person.[17] The literature thus ascribes to the entrepreneur a mix of conventional selfishness and a kind of directed altruism.[18] (Later we will address the case where the entrepreneur is not altruistic.) The problem is that the consumer cannot verify whether the

[16] *See* Energy Policy Act of 2005, Pub. L. No. 109-58, §§ 1344, 1347, 119 Stat. 594, 459-463 (2005) (providing tax incentives to ethanol and bio-diesel producers). The government also provides tax credits to drug companies for clinical research under the Orphan Drug Act. *See* Pub. L. No. 97-414, 96 Stat. 2049 (codified as amended at 21 U.S.C. § 360ee(b)3 (2006)).

[17] We use the model of Glaeser and Shleifer. *See* Edward Glaeser & Andrei Shleifer, *Not-for-profit Entrepreneurs*, 81 J. PUB. ECON., 99-115 (2001). Hansmann originated the idea that the NFP form solves a problem of asymmetric information but did not assume that the entrepreneur was altruistic. *See* Hansmann, *The Role of Nonprofit Enterprise*, *supra* note 15 at 898.

[18] We will follow the literature in using the term altruism, but clearly the term is not used synonymously with, say, having a preference to maximize social welfare. *See* Anup Malani, Tomas Philipson, & Guy David, *Firm Behavior in the Non-Profit Sector: A Synthesis and Empirical Evaluation* in THE GOVERNANCE OF NOT-FOR-PROFIT FIRMS 186 n. 5 (Edward Glaeser ed., 2003) (synthesizing literature on pure and impure altruism). It means, in this context, that the entrepreneur has a preference for engaging in some activity (producing good operas, helping a type of poor person, etc.) that is shared by the consumer; by contrast, the entrepreneur's "selfish" preferences, which higher income allows him to better satisfy, are not shared by the consumer.

entrepreneur satisfied her promise to give 80% of his money to the beneficiary. Technically speaking, this means the entrepreneur sells a product (transferring charitable money to a beneficiary) whose quality (percentage throughput) is nonverifiable, that is, cannot be stipulated in a contract that is enforceable by a court.

Let us abstract from the charity context for a moment. A consumer is willing to pay more for the product if it is of high quality than if it is low quality. Without loss of generality, we shall assume that the consumer is not willing to pay anything at all for the low quality product. The entrepreneur can set up either a FP firm or a NFP firm. If she sets up the FP firm, she receives (as sole shareholder) all the profits of the firm – revenues minus costs. If she sets up the NFP firm, she is legally required to accept a relatively flat salary – it cannot be functionally equivalent to equity. The law requires the NFP firm to retain earnings or spend it consistently with the firm's purpose. The entrepreneur may be able to convert some excess income into perquisites such as a nice office, but she values these perquisites less than the income itself. The effect of choosing the NFP form over the FP form is that the entrepreneur's payoff from operating the firm is reduced.

Why, then, would the entrepreneur be willing to choose NFP status? The answer is that the consumer may be willing to pay more for the product if the firm has taken the NFP form than if it has taken the FP form.[19] Indeed, in our extreme case the consumer is willing to pay nothing for a product produced by the FP firm. The reason is that the FP firm cannot commit itself to produce the high quality product. Because the entrepreneur receives revenues minus costs, she has strong incentives to produce a low quality good to reduce costs. For this reason, the consumer refuses to buy the product of the FP firm. By contrast, the entrepreneur's incentives to shirk on quality are blunted if she chooses NFP status. She gains less (ex post) by shirking on quality because the increased "profit" takes the form of low value perquisites. At the same time, if she shirks on quality, she loses the altruistic benefit of producing a high quality product. As long as the entrepreneur is sufficiently altruistic and the nonverifiable component of the product's quality is sufficiently high, the entrepreneur will choose NFP status and be able to sell the product.[20]

The NFP form solves a contracting failure that results from the fact that courts cannot verify the quality of the product. The nondistribution constraint blunts the

---

[19] There is an empirical debate about this issue; see infra note 28 and text accompanying that note.

[20] What makes the coupling so awkward in the context of the agency theory is that the nondistribution constraint can be thought of or implemented as a confiscatory tax on the NFP firm or the entrepreneur – the opposite of a subsidy for either. The nondistribution constraint – the key to the agency theory – is currently implemented by a promise by the entrepreneur not to distribute profits. If she does, she will lose her NFP status and be taxed as a FP on the profits. Another way to implement the non-distribution constraint, however, is to tax a firm that takes NFP status not at the FP tax rate, but at a 100% tax rate. This will discourage profit making even more effectively than does the current implementation of the constraint because the implicit penalty becomes explicit and greater. A third way to implement the non-distribution constraint is to raise the personal income tax on the NFP entrepreneur (or anyone else who controls the assets of the firm). Specifically, the government should tax the entrepreneur's income at a 100% marginal rate above the level that constitutes a competitive salary. This too would reduce any incentive the entrepreneur has to make profits.

incentive of the entrepreneur to shirk by limiting the return that the entrepreneur receives from the operation of the firm. The government audits the firm and punishes it if, in form or in function, the firm issues equity to the entrepreneur. Suppose, for example, that the entrepreneur pays herself a flat salary plus an annual bonus equal to the difference between the firm's revenues and costs in good years, and takes a pay cut in bad years. Because the entrepreneur has simply disguised her equity interest, the IRS would penalize her by stripping the firm of its nonprofit status and taxing it on its profits.[21] Thus, the NFP form solves the contracting problem by substituting a verifiable proxy (the firm's receipt of funds and payment of expenses) for the nonverifiable factor (the quality of the product). The proxy is accurate – in the sense that the firm's balance sheet is reliably correlated with quality – because the entrepreneur is partially altruistic and thus can be expected to behave more altruistically (thus enhancing quality in the interest of the consumer) if and only if the sensitivity of income to cost-cutting is reduced.

1. The Non-Altruistic Entrepreneur

One problem with the agency theory is that it implies that non-altruistic entrepreneurs, who are free to exploit the NFP form, will be given a tax break even though she has no incentive to produce a higher quality product. Although the nondistribution constraint may discourage the non-altruistic entrepreneur from making a low quality product to increase her personal income, it will not discourage her from making low quality products to increase her leisure or reduce her work effort. To put it another way: eliminating the profit incentive to shirk on quality does not eliminate other incentives to shirk on quality.[22]

The reader will raise two objections. First, wouldn't the non-altruistic entrepreneur still produce higher quality products in the nonprofit setting than in the for-profit setting, which encourages cost-cutting at the expense of quality? Perhaps, but not necessarily. If working long hours is necessary to produce a high quality product, the non-altruistic entrepreneur who values her leisure would produce a low quality product whether it would raise her salary (in the for-profit setting) or not (in the nonprofit setting). Second, why would a non-altruistic entrepreneur choose the nonprofit form? The answer is the information asymmetry between consumers and entrepreneurs. Because consumers know that all nonprofit entrepreneurs may not be altruistic, they are willing to

---

[21] The IRS now may impose intermediate sanctions by assessing fines and penalties for excessive compensation transactions. *See* I.R.C. § 4958 (2006).

[22] This is just a specific case of a more general problem. The contract failure theory is a version of the multitask principal-agent problem. *See* Bengt Holmstrom & Paul Milgrom, *Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design,* 7 J.L. ECON. & ORG. 24 (1991). The principal – the consumer – would like the agent – to engage in two tasks: produce a high quality product and keep down costs. The problem is that these tasks reflect a tradeoff, i.e., one way to lower costs is to produce a low quality product, and the principal-consumer cannot verify quality. The principle can encourage the agent to engage in cost-reduction, e.g., by letting the agent keep the profits of the endeavor. But a lesson of the multitask literature is that if the principal encourages one task but not the other, the agent will only engage in the first task. It is not a complete solution to eliminate the incentive on all tasks, because then the agent will not work. In the nonprofit context, eliminating the incentive to cut costs may result in new work rather than enhanced quality.

pay less for nonprofit products than they would if they could be assured that all nonprofit entrepreneurs were altruistic. But as long as there are at least some altruistic entrepreneurs, the consumers are willing to pay more for nonprofit products, which might be high quality, than for for-profit products, which are always low quality. And in our simple example, consumers value low quality products at zero.

Although the nonprofit story works well with altruistic entrepreneurs, it weakens significantly when there are non-altruistic entrepreneurs. This is a significant problem because, like product quality, the altruistic preferences of entrepreneurs are not verifiable. In other words, the nonprofit form replaces one non-verifiable condition (quality of the product or service) with another (altruism of the entrepreneur). If consumers know the fraction of nonprofit entrepreneurs who are altruistic, they know the probability of obtaining a high quality product and can adjust the price they are willing to pay nonprofits to account for the risk of poor quality. But it is doubtful that consumers know this fraction any more than they know which entrepreneurs in particular are altruistic.

2. *Substitutes for the Non-Distribution Constraint*

Another problem with the agency theory is that it implicitly – and incorrectly – assumes that the non-distribution constraint cannot be established by contract. For-profit firms can solve the non-contractible quality problem just as well as the nonprofit firm can. Specifically, the for-profit can promise consumers, by contract, that they will not distribute profits to their managers or workers.[23] Unlike quality, profits are verifiable; so this is an enforceable contract. And it achieves the same incentives as the nonprofit form. Indeed, this solution is basically a contractual implementation of the incentive scheme embodied by the nonprofit form.

What exactly would such a contract look like? There are two possibilities. First, the entrepreneur would start a for-profit firm rather than a nonprofit firm, but hire a manager to run the firm. The entrepreneur would promise consumers that the manager would control the firm; that the manager would be paid a fixed wage; that the manager would be prohibited from owning any shares in the firm; and that the entrepreneur would limit the perquisites that the manager could extract from the firm. These promises, along with the firm's product, would be part of the sales contract for that product. The

[23] This idea is related to Jensen's "free cash flow theory" for why shareholders may prefer the issuance of debt. Michael C. Jensen, *Agency Cost Of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AMER. ECON. REV. 323 (1986). In firms with a lot of uncommitted or free cash flows, there is a risk that managers will use these cash flows to make investments that are not in the interests of shareholders. Therefore, shareholders may prefer that the firm convert equity to debt because servicing debt will consume free cash flows. Equity does not do the same because issuance of dividends is optional for managers. The debt in Jensen's theory serves to limit managers' discretion by limiting their resources. The non-distribution contract clause we propose also serves to limit managers' discretion. But the beneficiary is not the shareholder, which in our model is the same as the manager. Rather, the beneficiary is the consumer or donor, who is ensured that the manager will not shirk on quality to raise profits. Moreover, whereas debt limits the resources available to managers to engage in moral hazard, the non-distribution clause curbs the incentives of managers to engage in moral hazard.

entrepreneur could also hire an auditor such as Price Waterhouse Coopers to police the contract. The auditor would be the private analogue to the state attorney general or the IRS in the nonprofit setting. The entrepreneur – and other investors – would be able to keep the firm's profits after production costs and paying the manager. If the entrepreneur instead funneled profits or provided additional perquisites to the manager, the auditor would blow the whistle, and the consumers could sue the entrepreneur for breach of contract.

Another approach would be for the entrepreneur to run the firm herself, but offer a cost-plus pricing scheme.[24] In this scheme, the consumer would pay a final price that reflects costs, plus the entrepreneur's opportunity cost of time. This could be implemented by billing the consumer after all costs have been tallied and the product has been delivered. Alternatively, the firm could refund to the consumers any profits it makes during the year. Either way, the firm would be the functional equivalent of a consumer-cooperative with the entrepreneur taking the role of the manager. The consumers, rather than the entrepreneur, would serve as residual claimants. If the entrepreneur instead pocketed the profits, the consumers would be able to sue her for breach of contract.

The key to both contracts is that the person in control of the firm – whether a manager hired by the entrepreneur or the entrepreneur herself – receives a flat wage. This eliminates the incentives to cut costs in a manner that sacrifices quality. So long as the person in control of the firm is altruistic, he or she will substitute higher quality for profits. (Note that, where the entrepreneur delegates control to a manger, it is the manger and not the entrepreneur who must be altruistic.)

A possible objection to the contractual implementation of nonprofit incentives is that they do not take advantage of the government's power to audit. As we saw before, the NFP is monitored by state attorneys general and the IRS, which penalizes the NFP if it produces profits for its stakeholders. By contrast, our contractual implementation would require consumers to detect breaches themselves or rely on private auditors to blow the whistle, and then the consumers would have to take the trouble of filing a lawsuit.

But this objection misses the mark. Monitoring by attorneys general and regulatory agencies is expensive, and monitoring by consumers and private auditors is expensive. There is no reason to think that the former is cheaper than the latter.[25] Indeed,

---

[24] The cost-plus contract is familiar from the construction industry. Although many people criticize the cost-plus contract in the construction industry because it does not give contractors an incentive to minimize expenses, it should, by the same token, work admirably when the entrepreneur is a partial altruist who also cares about income – our assumptions.

[25] Indeed, many statutes authorize private citizens – self-appointed "private attorney[s] general" *Newman v. Piggie Park Enterprises, Inc.*, 390 U.S. 400, 402 (1968) – to enforce laws intended to promote public policies rather than the interests of the private citizens. *See, e.g.,* Private Securities Litigation Reform Act**,** Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.) (authorizing private securities fraud actions); False Claims Act, 31 U.S.C. §§ 3729(a)(A), 3730(b) (2006) (authorizing private qui tam fraud actions); Toxic Substances Control Act, 15 U.S.C. §§ 2601-19(a) (2006) (allowing private citizen suits against violators).

the evidence suggests that state attorneys general rarely prosecute trustees of nonprofit firms for violations of their fiduciary duties and the IRS almost never revokes a firm's nonprofit status.[26] It may well be that private auditing and litigation would be superior to the certain system, or that some mixed system—in which government auditing supplements private litigation—would be optimal.

In a world without tax preferences for NFP firms, some entrepreneurs would choose the NFP form and others would choose the FP form; among the latter, some would offer to forgo profits by contract and others would not. Donors or consumers would sometimes deal with the first type of entrepreneur and sometimes deal with the second or third type. The agency theory can explain why an entrepreneur would make a no-profit promise by choosing the NFP form and the nondistribution constraint. It does not suggest that an entrepreneur cannot implement the same promise via private contract. Therefore, the theory cannot explain why the government should provide tax subsidies to entrepreneurs who choose the NFP form rather than a no-profit contractual commitment. In short, the agency theory, like the public goods theory, fails to justify the coupling of tax benefits and the NFP form.[27]

We should add that there is mixed evidence that consumers in markets with NFP firms place value on the non-contractible quality that the non-distribution constraint protects.[28] Interestingly, in the markets that are studied – hospitals, nursing homes and

---

[26] *See* John F. Coverdale, *Preventing Insider Misappropriation of Not-for-profit Heath Care Provider Assets: A Federal Tax Law Prescription*, 73 WASH. L. REV. 1, 10 (1998).

[27] The main goal of this subsection has been to demonstrate that FP firms can mimic NFP incentives via contract. But there is a larger point to be made. There are many ways for an entrepreneur to commit to selling a product with high nonverifiable quality. One is to take the NFP form – the organizational solution suggested by Hansmann et al. A second is to employ the flat-wage contracts for managers that we suggest. Yet a third is to rely on repeated dealings and the formation of a reputation for producing high quality products. A fourth is for the consumer to hire an expert to verify that the product is of high quality.

Each of these mechanisms has an implicit agency cost. This cost is the difference between the social cost of obtaining a high quality product with that mechanism and the social cost of obtaining a high quality product assuming quality were verifiable. The agency cost with the NFP form has two major components: the cost of funding state attorney general and IRS enforcement of the non-distribution constraint and the higher cost of production in the absence of incentives to make the production process more efficient. The agency cost with the contract analog to NFP status also has two components: the cost of a private auditor of the nonprofit pledge and a less efficient production process.

Consumers ought to (and, if left to their own devices, will) choose between the different solutions based on their agency cost. Therefore, the entrepreneur's choice between NFP status and a no-profit contract offered as a FP firm is largely driven by the cost of public versus private enforcement. Consumers may find that public enforcement is not always the cheapest way to secure high quality.

[28] *Compare* Tomas Philipson, *Asymmetric Information and the Not-for-profit Sector: Does Its Output Sell at a Premium?* in THE CHANGING HOSPITAL INDUSTRY: COMPARING NOT-FOR-PROFIT AND FOR-PROFIT INSTITUTIONS 325-45 (David M. Cutler ed.., 2000) (using data from the nursing home industry and finding no statistically significant difference between the prices of NFP and FP homes, suggesting that the NFP form provides no advantage with respect to non-contractible quality); Anup Malani & Guy David, Forget Quality: Do Non-profits Even Signal Their Status? (2006) (working paper) (finding that most NFP firms do not bother to mention their NFP status in their marketing, suggesting that consumers believe NFP firms produce higher non-contractible quality); *and* Maria D. Fitzpatrick, *Can Prices Tell Us Anything about Whether a Firm's Status is a Signal to Consumers?* (2006) (working paper) (replicating Philipson's study and finding an NFP price advantage in one of two markets studied); Shin-Yi Chou, *Asymmetric*

childcare – have a significant FP presence. This is possible because these markets do not depend on donations and therefore FP firms are not handicapped by the exclusive tax deduction for donations to NFP firms. But the FP presence also indicates that FP firms can survive even if non-contractible quality has value, probably because they provide contractible quality in an efficient manner. Surely that would also be true in the charity market. In other words, some donors may choose NFP charities because of non-contractible quality, but others may choose FP charities because they are more efficient.

C. The Altruism Theory

A third theory that might justify coupling relies on the nondistribution constraint selectively attracting charitable entrepreneurs who are altruistic. Altruists confer benefits on third parties and the general public; therefore, their activities should be subsidized. If altruists are attracted to NFPs, then a good way to subsidize altruists may be to subsidize NFPs. Thus, we have a theory that justifies coupling the NFP form and tax subsidies.

Before criticizing this theory, we should say something about its provenance. Economists who have analyzed this theory do not advocate it as a justification for coupling; they are more interested in positive questions such as whether NFP and FP firms behave differently.[29] But the positive theory has surface appeal as a normative theory. So in this section, we convert the positive theory to a normative theory and then criticize the normative theory.

Suppose there are two types of entrepreneurs: those who care only about their income (non-altruists) and those who also care about producing a quality product (altruists).[30] In the charity context, quality would be how much of each dollar of a donation actually makes its way to the beneficiary. In the non-charity context, quality has its normal meaning, for example, better health care or a better opera. Unlike for the agency theory, we assume that quality is verifiable. Each of these entrepreneurs has to decide whether to form a NFP or FP firm. If an entrepreneur forms a NFP firm, she will receive only a fixed income. If her cost structure is such that she can make profits (revenues minus costs, including her salary) even at the competitive price for her output, she will not be able to take that profit home as income. She can, however, spend her profit on producing a higher quality product. If an entrepreneur forms a FP firm, she not only receives a salary, but can also take home any profit the firm makes. Obviously, if the entrepreneur is a non-altruist, then she will be attracted to the FP form. However, if the entrepreneur also cares about product quality, she may be indifferent between the FP and

---

Information, Ownership and Quality of Care: An Empirical Analysis of Nursing Homes, 21 J. HEALTH ECON. 293 (2002) (finding NFP nursing homes provide better care than FP nursing homes).

[29] *See* Joseph P. Newhouse, *Toward a Theory of Nonprofit Institutions: An Economic Model of a Hospital,* 60 AM. ECON. REV. 64 (1970); Lakdawalla & Philipson, *supra,* note 11.

[30] Standard models of the altruism theory (*see id.*) assume an imperfect altruism where the entrepreneur has preferences not directly for the welfare or consumption of beneficiaries, but for the entrepreneur's production of goods that beneficiaries might consume. *See also* Malani, Philipson and Guy, *supra* note 16. This is usually modeled as entrepreneurs having preferences for the quantity or quality of production. An exception is A.G. Holtman, *A Theory of Non-Profit Firms*, 50 ECONOMICA 443 (1983).

NFP forms. With the former, she draws a higher income. With the latter, she gets to produce a higher quality product, which directly makes her happy.

Here is where NFP tax breaks come in. They break the tie between the FP and NFP form for the altruist.[31] The altruist may prefer the NFP form because the tax break finances additional production of product quality. Whereas the altruist was previously indifferent between the FP-and-profit or NFP-and-quality choices, she will now prefer the NFP-and-quality option. As a result of the tax advantages, altruists are more likely to choose the NFP form, and will produce more goods than they would in the absence of the tax advantages.

However, the superficial appeal of coupling in this way dissolves under inspection. To understand why, consider the baseline case of a non-altruistic entrepreneur running a FP firm operating in a competitive market without tax breaks. Economic theory tells us that this entrepreneur will choose the quantity or quality of its output such that its marginal cost of production is equal to the market price.[32] By contrast, an altruist operating a NFP firm—that is, a firm subject to the non-distribution constraint—in the same market, also without a tax break will choose its output such that its average cost of production equals market price. This ensures the firm will break even.[33] A potential problem with average-cost pricing is that, given fixed costs and diminishing marginal productivity,[34] the marginal cost at that level of production is higher than the marginal cost of production with marginal cost pricing, and thus higher than price. Production at the point where marginal cost is greater than price is wasteful and thus potentially inefficient because the cost of the last unit of output is greater than its value to consumers, which is given by the price.

This is not a problem in the absence of NFP subsidies. The excess cost of production with average-cost pricing is paid for out of the pocket of the altruistic entrepreneur. That she voluntarily chose the NFP form and average-cost pricing simply

[31] The sorting of altruists and non-altruists among NFP and FP firms is actually more complicated than what is presented in the main text. The analysis in the main text assumes that there is heterogeneity in costs among entrepreneurs and costs are not correlated with altruism. Moreover, it focuses on marginally competitive entrepreneurs. Inframarginal entrepreneurs, that is, entrepreneurs with very low costs choose the FP form even if they are altruistic because the profits they make due to their large cost advantage outweighs the "warm-glow" value they get from producing more or higher quality output.

[32] The reason is that marginal-cost pricing maximizes profit. With diminishing marginal productivity and thus increasing marginal costs, producing one more unit has negative return because marginal cost is greater than the price. Producing fewer units is still profitable, but not as profitable as marginal-cost pricing because at the margin price is greater than marginal cost. Increasing production would yield incremental revenues greater than incremental costs.

[33] The reason is that the entrepreneur, because of the nondistribution constraint, cannot take home any of the profits she generates via marginal-cost pricing. Instead she produces more (or higher quality) output because she draws utility from quantity or quality of production. She can continue this until she runs out of money, that is, until her average cost equals price. In the standard neoclassical economic model, with fixed costs and diminishing marginal productivity, output at average-cost-equals-price is greater than output at marginal-cost-equals-price. Incidentally, if the entrepreneur is not altruistic but takes the NFP form, she will be indifferent between marginal-cost and average-cost pricing.

[34] These are standard assumptions in the neoclassical model of the firm, even in the case of quality rather quantity output. *See, e.g.*, Newhouse, *supra* note 29 at 68, Fig. 1.

reveals that she values the additional or higher quality production more than the wastefulness of that production. In other words, the extra production generates "warm-glow" consumption value for the altruistic entrepreneur that is not incorporated into the price of the good, which is driven by value of production only to consumers.[35] The "shadow" price of this warm-glow consumption is the excessive cost of its production. The entrepreneur would not be willing to pay this cost unless the warm-glow value was greater that shadow price. That she is indicates that the extra production is a net benefit to social welfare.

Average-cost pricing can be a problem, however, when the NFP firm is given a tax subsidy. This subsidy will lower the NFP firm's average costs, which will lead the altruistic entrepreneur to produce even more or higher quality goods than without the subsidy.[36] Thus, we have two contrary effects. On the one hand, more charitable goods are being produced than if the tax subsidy were not given. This is good. On the other hand, charitable goods are being produced at a higher cost than they would be if the tax subsidy were not given, and this extra cost is not voluntarily "absorbed" by the altruist, who engages in the extra production only to obtain the subsidy. This is bad. It is possible that the good effects are greater than the bad effects, but not necessarily so.

But the relevant question is not whether the good effects are greater than the bad effects, but whether the tax bias in favor of the NFP causes a more efficient delivery of charitable goods than tax evenhandedness. To answer this question, one must look at how the FP charity would behave if coupling were eliminated, and altruists were no longer driven to the NFP. In such a case, every extra unit of tax subsidy will cause a hypothetical FP charity to produce somewhat less charity than the NFP does, on the margin, but at lower cost. The argument for decoupling, then, comes down to the assertion that the NFP charity's combination of more charity at higher (average) cost is more socially beneficial than the FP charity's combination of not as much charity at lower (average) cost, so that differential tax treatment will encourage donors to give more to NFPs and not to FPs.

We are doubtful that the tradeoff favors the NFP subsidy. More important, even if a NFP tax subsidy were more productive than a FP subsidy, the implication is not that tax subsidies should be linked to the NFP form. Rather, it is that the government should abandon tax subsidies and directly contract for the production of public goods or goods with positive externalities, whether that production is by a NFP or FP firm. Government contracts pay both types of firm the market price for additional consumption. As we have already demonstrated, FP firms will efficiently produce goods at marginal cost. NFP firms will do so at average cost without a tax subsidy; this will be efficient because the additional production will be paid for out of the pockets of their altruistic entrepreneurs,

---

[35] *See* James Andreoni**,** *Impure Altruism and Donations to Public Goods: A Theory of Warm-Glow Giving*, 100 ECON. J. 464, 464-65 (1990).

[36] Lowering average cost does not stop average cost from increasing with output or quality. It simply lowers average cost for each level of output or quality. But at some higher level of output or quality, average cost will reach levels before the subsidy. In other words, the subsidy raises the level of quantity or quality at which average cost reaches a particular price.

who receive direct utility from such production. In neither case does the cost of production ever exceed the market price. Crucially, there is no sacrifice in quantity of production because the government can specify in the contract exactly how many (additional) units it wants produced.

Some readers might object that the government should not allow non-altruistic or "selfish" entrepreneurs to obtain profits from supplying charitable goods, and thus tax advantages for charitable NFPs are an appropriate way of ensuring that this does not happen. But this objection cannot be valid. Ordinary commercial enterprises make profits when the government gives them tax breaks for developing alternative sources of energy and so forth,[37] and indeed when the government contracts with them to supply disaster relief and similar goods. Unless one objects to all tax breaks for FP firms, and government contracts with them, one should not support tax breaks limited to NFP charities on the ground that they are operated by altruists.

D. Inefficiencies Resulting from Coupling

If we are right that no good theory explains the coupling of tax subsidies and the NFP form, then it follows that current law generates inefficiencies. We briefly survey here the two main sources of inefficiency.

First, coupling encourages inefficient production by rewarding non-altruistic entrepreneurs who take NFP status. Suppose there are three types of entrepreneurs: altruists, efficient non-altruists, and inefficient non-altruists. Among the last two, assume that the efficient non-altruist and the inefficient non-altruist are identical in all respects except that the inefficient non-altruist has higher production costs. Finally, assume that the quality of the product is verifiable. The efficient non-altruist will choose the FP form so that she can receive the full return on her investment; she does not need to use the NFP form because there is no need to assure the consumer of the quality of a product when quality is verifiable. The inefficient non-altruist, however, has an incentive to choose the NFP form purely because of its tax advantage.[38] Because of the tax advantage, the inefficient non-altruist may be able to sell her product at a competitive price, taking business away from more efficient entrepreneurs. But because the inefficient non-altruist has higher true costs, this shift in business is socially costly. In sum, providing a tax advantage to people who use the NFP form can give a competitive advantage to inefficient producers.

Second, current NFP law discourages talented altruists from establishing charitable enterprises. To see why, recall that the entrepreneur in the original model is both altruistic and self-interested in the sense that she cares about income. Imagine that a particular entrepreneur also is highly talented. In a world in which successful charitable organizations need donors, and donors can receive tax deductions only by donating to qualified NFP organizations, the highly talented and altruistic entrepreneur can operate a

---

[37] See supra note 16 (listing other tax breaks for FP firms).
[38] Relative to the corporate form; we assume that other forms, such as the LLC, are off the table.

charitable organization only if she is willing to take a large pay cut relative to what she could receive in the commercial sector. The reason for this is that the IRS enforces the nondistribution constraint by insisting that the entrepreneur receive no more than a comparable employee in the commercial sector. But a highly talented entrepreneur would have difficulty proving that her market compensation is higher than that of comparable employees in the commercial sector. This may explain why many entrepreneurs devote their early life to amassing wealth in commerce, and then start foundations only after they retire. It would be better if these entrepreneurs could amass wealth early in life by establishing successful FP charitable institutions.

E. Summary

Entrepreneurs who engage in charitable activities should be subsidized regardless of their motivation or the corporate form that they choose. Current law distorts behavior by encouraging entrepreneurs to choose corporate form based on tax consequences rather than efficiency.

IV. Does Existing Law Already Permit Decoupling?

One objection to our argument is that entrepreneurs who want to create FP charities that will benefit from tax subsidies can do so by engaging in sophisticated legal manipulation. If this objection is correct, then it is not necessary to change the law. In addition, if this objection is correct, it may suggest that the nonexistence of FP charities shows that FP charities actually are not viable—they have hidden inefficiencies or offend potential donors. However, we do not believe that this objection is correct.

Suppose that an entrepreneur wants to establish a charity that helps sick children in Africa, and also knows that her own incentives will be optimal if the charity is FP rather than NFP. To see how this might work, consider the familiar example of the NFP museum which wholly owns a FP gift shop. Donors to the museum receive tax benefits even though the gift shop makes profits. The reason is that all of the gift shop's profits must be used by the museum for charitable ends, and cannot be distributed to the people who control the museum's activities.

Now consider a charitable entrepreneur who believes that the FP form would be most efficient for her charitable firm. Can't she simply set up an NFP shell, which wholly owns the FP core, which would then have optimal incentives to distribute the charity?[39] Imagine that the FP subsidiary receives the donations collected by the NFP shell, distributes the donations to the beneficiaries, and obtains "profits" equal to the difference between the fraction of the donor's dollar that are, by contract, assigned to overhead

[39] *See* M. Gregg Bloche, *Corporate Takeover of Teaching Hospitals*, 65 S. CAL. L. REV. 1035, 1040 (noting instances where NFP hospitals have signed management contracts with FP firms); POLICY & PROGRAM STUDIES SERV., U.S. DEP'T EDUC., EVALUATION OF THE PUBLIC CHARTER SCHOOLS PROGRAM 32-33 (2004) (describing NFP charter schools managed by FP entities).

expenses, and the fraction actually used for overhead expenses. For example, the "donation contract" provides that 80 cents on the dollar will reach beneficiaries, and be confirmed by an independent audit, and that the FP core will be allowed to keep any portion of the 20 cent balance that is not necessary for expenses.

The defect in this solution is easily seen. Because the NFP shell cannot distribute the profits from the FP core to its managers, the manager of the NFP shell does not have proper incentives to select efficient managers for the FP core or to monitor these managers to ensure that they do not shirk Moreover, if the FP core is really doing all the work within the NFP shell, the IRS is likely to call the shell a sham and withdraw the shell's tax benefits.

But why then does the museum choose the FP form for its gift shop? It is unlikely that the purpose is to improve the incentives of, say, the gift shop's manager or anyone else. The likely reason is that, because of the unrelated business income tax, the NFP museum is taxed just as a FP museum would be on the profits from the gift shop. Organizing the gift shop as a FP entity simplifies the accounting for purposes of calculating the tax.

V. Mixed Charities and Corporate Responsibility

Our conclusions have larger significance for an increasingly important phenomenon, that of, "corporate responsibility." Corporate responsibility refers to the practice of many corporations of donating money or services to a charitable cause or refraining from profitable activities that offend moral sensibilities. Firms in the first category includes McDonald's, which provides in-kind grants to Ronald McDonald House, an independent charity,[40] and the many firms that donated money and services to victims of the Katrina hurricane disaster.[41] Firms in the second category includes Nike and other clothing manufacturers which avoid purchasing supplies from sweatshops in foreign countries even though those sweatshops comply with local law; Time Warner and many other companies that support the arts; Price Waterhouse and other firms that refuse to do business with repressive regimes such as the government of Myanmar; and Starbucks, Whole Foods, and other retailers that purchase supplies from farmers who use ecologically benign production methods or who are poor.[42] We will call the second category of firms "mixed charities." This category is our focus. We argue that just as

---

[40] http://www.rmhc.org/rmhc/index/about.html.

[41] *See* Companies Pitch In, CNNMoney.com, Sept. 15, 2005, available at http://money.cnn.com/2005/08/31/news/fortune500/firms_hurricane/ (listing dozens of firms that gave millions of dollars in charity, both cash and in kind, for hurricane relief aid).

[42] These firms and many others have web pages devoted to corporate responsibility. See, e.g., http://www.nike.com/nikebiz/nikebiz.jhtml?page=29; http://www.timewarner.com/corp/citizenship/index.html; http://www.mcdonalds.com/corp/values/socialrespons.html; http://corporate.disney.go.com/corporate/corporate_responsibility.html; http://www.starbucks.com/aboutus/csr.asp; http://www.pwc.com/extweb/newcoatwork.nsf/docid/1AB4D9C5A057936B80256C2A003C26DD.

"pure" FP charitable firms should receive the 501(c)(3) tax benefit, so should FP mixed charities, to the extent of their charitable activity.

The argument is based on the assumption that some commercial and charitable operations are likely to benefit from economies of scope—they can be provided more cheaply by the same firm that by separate firms. Suppose that many people believe that poor third world coffee farmers should receive aid. Currently, a donor can help these farmers by contributing to a pure NFP charity, which would then give cash or in-kind help to the farmers. In addition, a donor can help these farmers by purchasing their products from Starbucks and other stores even though the quality-adjusted price of their coffee beans is higher than the price of comparable beans produced by large commercial operations. However, because Starbucks is a FP firm, the purchaser of the beans cannot take a tax deduction for the portion of the price that is attributable to the donation (as opposed to the portion that is attributable to the consumption value of the good). This creates a distortion: people will prefer to donate to the pure charity in order to obtain the tax benefit when there is no reason to think that the pure charity produces a social benefit greater than Starbucks. Indeed, to the extent that Starbucks can exploit economies of scope from combining its commercial and charitable coffee bean purchasing operations, the tax subsidy pushes donations from the more efficient charity to the less efficient charity. In sum, if economies of scope are substantial, as they surely are in some case, then coupling tax breaks and NFP status interferes with the efficient production of charitable goods.

There are two main objections to this argument. First, allowing commercial firms to offer tax advantages to consumers whose dollars partially fund charitable activities might seem administratively complex. Starbucks would need to give customers a receipt that distinguishes the charitable and commercial components of the price. If a bag of fair trade coffee beans costs $10, and comparable non-fair beans costs $9, then the receipt should show a $1 donation. The customer could use the receipt as evidence for deductions claimed on her tax return. (Starbucks could also keep track of this information and send customers annual statements.) Meanwhile, Starbucks would need to prove to the IRS that the customer's beans were purchased from a qualified entity. This would also require extensive recordkeeping. We are agnostic as to whether the benefits justify these administrative costs; however, we should point out that this type of recordkeeping is quite common in related contexts. For example, charities frequently invite donors to dinner receptions, charge them $W, and then provide a receipt that shows that some portion of the $W price was used to pay for a service (the dinner), and is thus not tax deductible. For this reason, the administrative costs of our scheme are not likely to be excessive.

Second, many people argue that firms like Starbucks do not engage in "real" charity; their apparently charitable activity is simply a cynical marketing gimmick. Indeed, managers of firms have a duty to maximize the profits of shareholders, and if they really meant to give away the firm's money, they could be sued. Therefore, it cannot be the case that managers are acting altruistically, and if they are not, then firms should not obtain additional tax benefits.

This argument, however, is seriously mistaken. What matters is not the firms' motive, but the effect of their behavior. To understand why, imagine that Starbucks can increase its profits by exactly the same amount in two ways. First, it can invest in expensive billboards which will bring more customers to its stores. Second, it can provide donations to fair-trade farmers while publicizing this activity, which will bring the same number of customers to its stores as the billboards. Each investment costs $X, while bringing in an additional Y customers, who generate increased profits of $Z each, where Y*$Z > $X.

Assuming that people generally care about the well-being of farmers, while being indifferent to the existence of billboards, it makes sense to subsidize Starbucks's fair-trade campaign while not subsidizing the billboard campaign. It does not matter whether "Starbucks" (or its managers or shareholders) act from altruistic or selfish motivates; what matters is that the resulting activity produces social benefits. This, of course, is a general point, one that applies to all firms that engage in socially desirable behavior.

VI. Conclusion: A Proposal

Existing theories of NFP status are not persuasive justifications for coupling the NFP form and tax benefits. The government should not condition subsidies on taking the NFP form, that is, complying with the nondistribution constraint. Exclusively subsidizing this form only distorts entrepreneurs' incentives. We do not take a position on whether governments should subsidize charitable activities undertaken by firms; rather our point is that *if* government should subsidize such charitable activities, then the subsidies should be available to FP as well as NFP firms. This is the case for FP charities.

If we are correct, why does current law grant a tax break to NFP firms that is not available to FP firms? One possible reason is historical accident, but the staying power of this error might be due, we think, to a pervasive confusion in the public mind about motivation and effect. An intuitive view is that NFP firms deserve a tax subsidy because NFP entrepreneurs are altruistic, whereas FP entrepreneurs are greedy—a view reflected in the commonly held notion that corporations engage in charitable activities only for self-interested marketing reasons. But the NFP form, by conferring tax advantages, appeals to non-altruists as well as altruists. The only way for the law to encourage truly altruistic behavior—that is, behavior motivated by a concern for others, not by a concern for oneself—is by *not* rewarding it.[43] The relevant consideration for the law is not whether the entrepreneur is altruistic but whether the effect of the entrepreneur's action is socially beneficial. If it is socially beneficial, and if ordinary market forces do not provide sufficient incentive for people to engage in that action, then a subsidy may be appropriate. Because the effect of the entrepreneur's behavior is unrelated to her incentives to choose between the NFP or FP form, the choice of form does not provide grounds for a tax subsidy.

---

[43] *Cf.* Richard Morris Titmuss, THE GIFT RELATIONSHIP: FROM HUMAN BLOOD TO SOCIAL POLICY (expanded ed. 1997) (arguing that voluntary blood donation is superior to commercializing blood transfer on public policy grounds).

Readers with comments should address them to:

Professor Eric Posner
University of Chicago Law School
1111 East 60th Street
Chicago, IL 60637
eposner@uchicago.edu

Chicago Working Papers in Law and Economics
(Second Series)

For a listing of papers 1–174 please go to Working Papers at http://www.law.uchicago.edu/Lawecon/index.html

175. Douglas G. Baird, In Coase's Footsteps (January 2003)
176. David A. Weisbach, Measurement and Tax Depreciation Policy: The Case of Short-Term Assets (January 2003)
177. Randal C. Picker, Understanding Statutory Bundles: Does the Sherman Act Come with the 1996 Telecommunications Act? (January 2003)
178. Douglas Lichtman and Randal C. Picker, Entry Policy in Local Telecommunications: *Iowa Utilities* and *Verizon* (January 2003)
179. William Landes and Douglas Lichtman, Indirect Liability for Copyright Infringement: An Economic Perspective (February 2003)
180. Cass R. Sunstein, Moral Heuristics (March 2003)
181. Amitai Aviram, Regulation by Networks (March 2003)
182. Richard A. Epstein, Class Actions: Aggregation, Amplification *and* Distortion (April 2003)
183. Richard A. Epstein, The "Necessary" History of Property and Liberty (April 2003)
184. Eric A. Posner, Transfer Regulations and Cost-Effectiveness Analysis (April 2003)
185. Cass R. Sunstein and Richard H. Thaler, Libertarian Paternalism Is Not an Oxymoron (May 2003)
186. Alan O. Sykes, The Economics of WTO Rules on Subsidies and Countervailing Measures (May 2003)
187. Alan O. Sykes, The Safeguards Mess: A Critique of WTO Jurisprudence (May 2003)
188. Alan O. Sykes, International Trade and Human Rights: An Economic Perspective (May 2003)
189. Saul Levmore and Kyle Logue, Insuring against Terrorism—and Crime (June 2003)
190. Richard A. Epstein, Trade Secrets as Private Property: Their Constitutional Protection (June 2003)
191. Cass R. Sunstein, Lives, Life-Years, and Willingness to Pay (June 2003)
192. Amitai Aviram, The Paradox of Spontaneous Formation of Private Legal Systems (July 2003)
193. Robert Cooter and Ariel Porat, Decreasing Liability Contracts (July 2003)
194. David A. Weisbach and Jacob Nussim, The Integration of Tax and Spending Programs (September 2003)
195. William L. Meadow, Anthony Bell, and Cass R. Sunstein, Statistics, Not Memories: What Was the Standard of Care for Administering Antenatal Steroids to Women in Preterm Labor between 1985 and 2000? (September 2003)
196. Cass R. Sunstein, What Did *Lawrence* Hold? Of Autonomy, Desuetude, Sexuality, and Marriage (September 2003)
197. Randal C. Picker, The Digital Video Recorder: Unbundling Advertising and Content (September 2003)
198. Cass R. Sunstein, David Schkade, and Lisa Michelle Ellman, Ideological Voting on Federal Courts of Appeals: A Preliminary Investigation (September 2003)
199. Avraham D. Tabbach, The Effects of Taxation on Income Producing Crimes with Variable Leisure Time (October 2003)
200. Douglas Lichtman, Rethinking Prosecution History Estoppel (October 2003)
201. Douglas G. Baird and Robert K. Rasmussen, Chapter 11 at Twilight (October 2003)
202. David A. Weisbach, Corporate Tax Avoidance (January 2004)
203. David A. Weisbach, The (Non)Taxation of Risk (January 2004)
204. Richard A. Epstein, Liberty versus Property? Cracks in the Foundations of Copyright Law (April 2004)
205. Lior Jacob Strahilevitz, The Right to Destroy (January 2004)
206. Eric A. Posner and John C. Yoo, A Theory of International Adjudication (February 2004)
207. Cass R. Sunstein, Are Poor People Worth Less Than Rich People? Disaggregating the Value of Statistical Lives (February 2004)
208. Richard A. Epstein, Disparities and Discrimination in Health Care Coverage; A Critique of the Institute of Medicine Study (March 2004)
209. Richard A. Epstein and Bruce N. Kuhlik, Navigating the Anticommons for Pharmaceutical Patents: Steady the Course on Hatch-Waxman (March 2004)
210. Richard A. Esptein, The Optimal Complexity of Legal Rules (April 2004)
211. Eric A. Posner and Alan O. Sykes, Optimal War and *Jus Ad Bellum* (April 2004)
212. Alan O. Sykes, The Persistent Puzzles of Safeguards: Lessons from the Steel Dispute (May 2004)
213. Luis Garicano and Thomas N. Hubbard, Specialization, Firms, and Markets: The Division of Labor within and between Law Firms (April 2004)
214. Luis Garicano and Thomas N. Hubbard, Hierarchies, Specialization, and the Utilization of Knowledge: Theory and Evidence from the Legal Services Industry (April 2004)
215. James C. Spindler, Conflict or Credibility: Analyst Conflicts of Interest and the Market for Underwriting Business (July 2004)
216. Alan O. Sykes, The Economics of Public International Law (July 2004)

217. Douglas Lichtman and Eric Posner, Holding Internet Service Providers Accountable (July 2004)
218. Shlomo Benartzi, Richard H. Thaler, Stephen P. Utkus, and Cass R. Sunstein, Company Stock, Market Rationality, and Legal Reform (July 2004)
219. Cass R. Sunstein, Group Judgments: Deliberation, Statistical Means, and Information Markets (August 2004, revised October 2004)
220. Cass R. Sunstein, Precautions against What? The Availability Heuristic and Cross-Cultural Risk Perceptions (August 2004)
221. M. Todd Henderson and James C. Spindler, Corporate Heroin: A Defense of Perks (August 2004)
222. Eric A. Posner and Cass R. Sunstein, Dollars and Death (August 2004)
223. Randal C. Picker, Cyber Security: Of Heterogeneity and Autarky (August 2004)
224. Randal C. Picker, Unbundling Scope-of-Permission Goods: When Should We Invest in Reducing Entry Barriers? (September 2004)
225. Christine Jolls and Cass R. Sunstein, Debiasing through Law (September 2004)
226. Richard A. Posner, An Economic Analysis of the Use of Citations in the Law (2000)
227. Cass R. Sunstein, Cost-Benefit Analysis and the Environment (October 2004)
228. Kenneth W. Dam, Cordell Hull, the Reciprocal Trade Agreement Act, and the WTO (October 2004)
229. Richard A. Posner, The Law and Economics of Contract Interpretation (November 2004)
230. Lior Jacob Strahilevitz, A Social Networks Theory of Privacy (December 2004)
231. Cass R. Sunstein, Minimalism at War (December 2004)
232. Douglas Lichtman, How the Law Responds to Self-Help (December 2004)
233. Eric A. Posner, The Decline of the International Court of Justice (December 2004)
234. Eric A. Posner, Is the International Court of Justice Biased? (December 2004)
235. Alan O. Sykes, Public vs. Private Enforcement of International Economic Law: Of Standing and Remedy (February 2005)
236. Douglas G. Baird and Edward R. Morrison, Serial Entrepreneurs and Small Business Bankruptcies (March 2005)
237. Eric A. Posner, There Are No Penalty Default Rules in Contract Law (March 2005)
238. Randal C. Picker, Copyright and the DMCA: Market Locks and Technological Contracts (March 2005)
239. Cass R. Sunstein and Adrian Vermeule, Is Capital Punishment Morally Required? The Relevance of Life-Life Tradeoffs (March 2005)
240. Alan O. Sykes, Trade Remedy Laws (March 2005)
241. Randal C. Picker, Rewinding *Sony*: The Evolving Product, Phoning Home, and the Duty of Ongoing Design (March 2005)
242. Cass R. Sunstein, Irreversible and Catastrophic (April 2005)
243. James C. Spindler, IPO Liability and Entrepreneurial Response (May 2005)
244. Douglas Lichtman, Substitutes for the Doctrine of Equivalents: A Response to Meurer and Nard (May 2005)
245. Cass R. Sunstein, A New Progressivism (May 2005)
246. Douglas G. Baird, Property, Natural Monopoly, and the Uneasy Legacy of *INS v. AP* (May 2005)
247. Douglas G. Baird and Robert K. Rasmussen, Private Debt and the Missing Lever of Corporate Governance (May 2005)
248. Cass R. Sunstein, Administrative Law Goes to War (May 2005)
249. Cass R. Sunstein, Chevron Step Zero (May 2005)
250. Lior Jacob Strahilevitz, Exclusionary Amenities in Residential Communities (July 2005)
251. Joseph Bankman and David A. Weisbach, The Superiority of an Ideal Consumption Tax over an Ideal Income Tax (July 2005)
252. Cass R. Sunstein and Arden Rowell, On Discounting Regulatory Benefits: Risk, Money, and Intergenerational Equity (July 2005)
253. Cass R. Sunstein, Boundedly Rational Borrowing: A Consumer's Guide (July 2005)
254. Cass R. Sunstein, Ranking Law Schools: A Market Test? (July 2005)
255. David A. Weisbach, Paretian Intergenerational Discounting (August 2005)
256. Eric A. Posner, International Law: A Welfarist Approach (September 2005)
257. Adrian Vermeule, Absolute Voting Rules (August 2005)
258. Eric Posner and Adrian Vermeule, Emergencies and Democratic Failure (August 2005)
259. Douglas G. Baird and Donald S. Bernstein, Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain (September 2005)
260. Adrian Vermeule, Reparations as Rough Justice (September 2005)
261. Arthur J. Jacobson and John P. McCormick, The Business of Business Is Democracy (September 2005)
262. Adrian Vermeule, Political Constraints on Supreme Court Reform (October 2005)
263. Cass R. Sunstein, The Availability Heuristic, Intuitive Cost-Benefit Analysis, and Climate Change (November 2005)
264. Lior Jacob Strahilevitz, Information Asymmetries and the Rights to Exclude (November 2005)
265. Cass R. Sunstein, Fast, Frugal, and (Sometimes) Wrong (November 2005)

266. Robert Cooter and Ariel Porat, Total Liability for Excessive Harm (November 2005)
267. Cass R. Sunstein, Justice Breyer's Democratic Pragmatism (November 2005)
268. Cass R. Sunstein, Beyond Marbury: The Executive's Power to Say What the Law Is (November 2005, revised January 2006)
269. Andrew V. Papachristos, Tracey L. Meares, and Jeffrey Fagan, Attention Felons: Evaluating Project Safe Neighborhoods in Chicago (November 2005)
270. Lucian A. Bebchuk and Richard A. Posner, One-Sided Contracts in Competitive Consumer Markets (December 2005)
271. Kenneth W. Dam, Institutions, History, and Economics Development (January 2006)
272. Kenneth W. Dam, Land, Law and Economic Development (January 2006)
273. Cass R. Sunstein, Burkean Minimalism (January 2006)
274. Cass R. Sunstein, Misfearing: A Reply (January 2006)
275. Kenneth W. Dam, China as a Test Case: Is the Rule of Law Essential for Economic Growth (January 2006)
276. Cass R. Sunstein, Problems with Minimalism (January 2006, revised August 2006)
277. Bernard E. Harcourt, Should We Aggregate Mental Hospitalization and Prison Population Rates in Empirical Research on the Relationship between Incarceration and Crime, Unemployment, Poverty, and Other Social Indicators? On the Continuity of Spatial Exclusion and Confinement in Twentieth Century United States (January 2006)
278. Elizabeth Garrett and Adrian Vermeule, Transparency in the Budget Process (January 2006)
279. Eric A. Posner and Alan O. Sykes, An Economic Analysis of State and Individual Responsibility under International Law (February 2006)
280. Kenneth W. Dam, Equity Markets, The Corporation and Economic Development (February 2006)
281. Kenneth W. Dam, Credit Markets, Creditors' Rights and Economic Development (February 2006)
282. Douglas G. Lichtman, Defusing DRM (February 2006)
283. Jeff Leslie and Cass R. Sunstein, Animal Rights without Controversy (March 2006)
284. Adrian Vermeule, The Delegation Lottery (March 2006)
285. Shahar J. Dilbary, Famous Trademarks and the Rational Basis for Protecting "Irrational Beliefs" (March 2006)
286. Adrian Vermeule, Self-Defeating Proposals: Ackerman on Emergency Powers (March 2006)
287. Kenneth W. Dam, The Judiciary and Economic Development (March 2006)
288. Bernard E. Harcourt: Muslim Profiles Post 9/11: Is Racial Profiling an Effective Counterterrorist Measure and Does It Violate the Right to Be Free from Discrimination? (March 2006)
289. Christine Jolls and Cass R. Sunstein, The Law of Implicit Bias (April 2006)
290. Lior J. Strahilevitz, "How's My Driving?" for Everyone (and Everything?) (April 2006)
291. Randal C. Picker, Mistrust-Based Digital Rights Management (April 2006)
292. Douglas Lichtman, Patent Holdouts and the Standard-Setting Process (May 2006)
293. Jacob E. Gersen and Adrian Vermeule, *Chevron* as a Voting Rule (June 2006)
294. Thomas J. Miles and Cass R. Sunstein, Do Judges Make Regulatory Policy? An Empirical Investigation of *Chevron* (June 2006)
295. Cass R. Sunstein, On the Divergent American Reactions to Terrorism and Climate Change (June 2006)
296. Jacob E. Gersen, Temporary Legislation (June 2006)
297. David A. Weisbach, Implementing Income and Consumption Taxes: An Essay in Honor of David Bradford (June 2006)
298. David Schkade, Cass R. Sunstein, and Reid Hastie, What Happened on Deliberation Day? (June 2006)
299. David A. Weisbach, Tax Expenditures, Principle Agent Problems, and Redundancy (June 2006)
300. Adam B. Cox, The Temporal Dimension of Voting Rights (July 2006)
301. Adam B. Cox, Designing Redistricting Institutions (July 2006)
302. Cass R. Sunstein, Montreal vs. Kyoto: A Tale of Two Protocols (August 2006)
303. Kenneth W. Dam, Legal Institutions, Legal Origins, and Governance (August 2006)
304. Anup Malani and Eric A. Posner, The Case for For-Profit Charities (September 2006)
305. Douglas Lichtman, Irreparable Benefits (September 2006)
306. M. Todd Henderson, Payiing CEOs in Bankruptcy: Executive Compensation when Agency Costs Are Low (September 2006)
307. Michael Abramowicz and M. Todd Henderson, Prediction Markets for Corporate Governance (September 2006)