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The best known account in recent legal or economic literature of why certain organizations use the nonprofit form, and when or why they ought to be tax-exempt, comes from Henry Hansmann.[1] Hansmann argues that the nonprofit form prevails where it does because it responds efficiently to problems of "contract failure" where behavior is hard to monitor.[2] For example, I might not trust a for-profit company to use my donation to provide famine relief in a foreign country or to render "complex personal services" such as nursing care, given the difficulty of observing performance directly.[3] The nonprofit structure is supposed to increase one's confidence in the company's good-faith behavior.[4]

Hansmann further argues that the nonprofit form can lead to inefficient under-investment in the sectors to which it is best suited, since nonprofits cannot attract conventional equity capital and have difficulty even attracting sufficient loan capital.[5] Tax exemption could be seen as responding to this inefficiency by allowing nonprofits to keep more of whatever cash they nonetheless succeed in attracting.[6]

How well do Hansmann's arguments hold up after close to twenty years? Overall, I would say they hold up well, but they are better at explaining nonprofits than at supporting tax exemption.[7] Moreover, Hansmann mainly emphasizes only one of the two key characteristics that nonprofit organizations generally share. In addition to being nonprofit in form, they generally provide services in fields that have a certain aura of

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1. *See* Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835 (1980).

2. *See id.* at 845.

3. *See id.* at 846.

4. *See id.* at 851-54. Hansmann notes, however, that nonprofit status "is a rather crude consumer protection device." *Id.* at 871.

5. *See* Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54 (1981).

6. *See id.* at 72-75.

7. *See id.* at 96. Hansmann argues far more strongly for the claim that the under-investment view provides the best available argument for nonprofits' tax exemption than for the claim that this view in fact supports the treatment of nonprofits under present law. *See id.* at 72-75.

virtue or public-spiritedness, making the word "charitable" not wholly inapposite. Consider § 501(c)(3) of the Internal Revenue Code, which lists the following exempt purposes: religious, charitable, scientific, testing for public safety, literary, educational, and prevention of cruelty to children or animals.[8] The nonprofit field was characterized by this focus on charity, virtue, or public-spiritedness even before the income tax created incentives for the link.[9] Surely both of the typical nonprofit's two key defining characteristics are important, and perhaps the greatest interest lies in explaining their overlap.

I. EXPLAINING NONPROFITS

With regard to explaining nonprofits, my favorite example to test the contract failure view is automobile repair shops. Here is a "complex personal service" or a setting rife with "contract failure," if ever there was one. All car-owners know the feeling of being told, "in addition to the oil change, you also need two thousand dollars of engine work." They often agree to have the costly extra work done because the risk of a car breakdown is high and they cannot judge for themselves, but certainly the for-profit setting arouses deep distrust. So why (so far as I know) are there no nonprofit automobile repair shops?

Hansmann discusses this very example,[10] but to my mind does not make quite enough of it. He suggests that, when people are buying private goods for their own personal consumption, contract failure is unlikely to be bad enough to require the very crude response that nonprofit status offers.[11] Presumably, the claim is that, in the private personal consumption setting, good faith performance is easier to observe. But is that really true? In the automobile repair case, how likely am I ever to find out if I needed the engine work that I agreed to? Is the case any different from, say, medical services, in which nonprofits play a major role? Indeed, is getting the needed information harder here than in the foreign famine relief case, where industry concentration, embodied by organizations such as the Red Cross, UNICEF, and the United Way, provides a stronger reputational bond than one can find in what is

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8. *See* I.R.C. § 501(c)(3) (1986).

9. *See, e.g.*, W. HARRISON WELLFORD & JANNE G. GALLAGHER, UNFAIR COMPETITION? THE CHALLENGE TO CHARITABLE TAX EXEMPTION 29-46 (1988) (discussing the historical tradition of nonprofit enterprise, in part to support the separate point that charging fees for charitable services has long been common).

10. *See* Hansmann, *supra* note 1, at 868-72.

11. *See id.* at 871.

clearly—presumably due to factors that affect the efficient scale of production—the more decentralized realm of repairing automobiles?[12]

Thus, one must examine more closely why there are nonprofits in such fields as charity work, the "high"—though generally not popular—arts, education, and medicine, but not in automobile repair, even though the "contract failure" problem may apply with comparable force to all. I think the answer can be approached from either the demand side, where people decide how to spend their money (with regard to both donations and purchases), or the supply side, where people decide what services to offer and in what settings to offer the services.

Curbing the profit motive through use of the nonprofit form initially leaves us with a black box. Yes, it may ease certain concerns about good faith performance, but what remains in their place? What all the typical nonprofit areas have in common is a fair chance of attracting workers who care about nonprofits; for example, people who want to do charity work, public radio, or academic scholarship, and may even be willing to accept a lower salary to do this sort of work. Prospective donors or service buyers know that these people exist, and not only worry less about bad faith or abuse, but have in mind a plausible and reassuring set of alternative motivations.

Someone who tried to offer automobile repair services on a nonprofit basis would have difficulty inspiring similar confidence. Prospective customers would probably conclude that it was either a scam, or that the lack of a profit motive did more harm than good by discouraging assiduous effort. Imagine what quality of service most people might expect if a government bureaucracy, with its similar lack of profit motive—say, New York's Department of Motor Vehicles—began offering automobile repair services to residents.

Shifting to the supply side,[13] suppose that you were thinking of establishing a nonprofit organization. Given the bar on attracting conventional equity, could you at least receive cheap and highly motivated labor? Here the loosely charitable activity focus is crucial. You might find people who want to do alms work, public radio, or scholarship, and who would forego a higher salary elsewhere, but it would be hard to find

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12. *See id.* at 870-71. Hansmann agrees that the efficient scale of production in an industry is important, and notes that where it is small the nonprofit form may make little difference in service providers' expected behavior. While he rightly emphasizes that the nonprofit constraint can make more of a difference in large organizations, he does not rebut the possibility that they also have an offsetting lesser need for the constraint because of their greater ability to post an effective reputational bond. *See id.*

13. *See id.* at 899-901. While Hansmann mainly provides a demand side explanation for nonprofit organizations, he provisionally sketches a supply side argument that resembles my own in an appendix. *See id.*

automobile repairmen with the same sentiments. In the traditional charitable fields, your nonprofit status might help to reassure them that you would do it in a suitable way, in effect, solving their contract failure problem as prospective employees. So, in the traditional nonprofit fields but not others, nonprofit organizations may have a supply side as well as a demand side advantage.

I would revise Hansmann's "contract failure" theory to rely more clearly and explicitly on expected taste. The taste element involves the fact that, in general, only nonprofits in fields with a loosely charitable, virtuous, or public-spirited halo or aura attract, and are known to attract, a certain type of motivated individual. In the end, however, Hansmann and I differ here in little beyond emphasis. He concedes that the nonprofit form may work better in some areas than others "for reasons rooted in cultural norms or individual preferences."[14] That he does not pursue this may reflect a tradition among economists, exemplified in a famous article by Gary Becker and George Stigler called *De Gustibus Non Est Disputandum*,[15] urging that one try to explain as many phenomena as possible without relying on detailed claims about people's underlying taste.[16] Relying on detailed claims about taste can be a type of cheating, because it often short-circuits empirical testing and might be made unnecessary by working harder within the more parsimonious conventional premises. Here, however, I believe it is unavoidable.

II. EXPLAINING TAX EXEMPTION

Why are nonprofits often tax-exempt? Without exemption, nonprofits would not only owe income tax, but also sales and property taxes, and they would pay higher postal rates. Whether or not these exemptions, low rates, and other benefits, such as the charitable deduction, are in the end correct policy, there is widespread agreement that they are at least plausible. Thus, even Stanley Surrey, the great foe of nearly all special incentives within the income tax, thought some form of government aid to charitable organizations might be justified.[17]

Hansmann is right to dismiss the earlier argument for income tax exemption by Boris Bittker and George Rahdert, which focuses on the

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14. *Id.* at 871.

15. *See* George J. Stigler & Gary S. Becker, *De Gustibus Non Est Disputandum*, 67 AM. ECON. REV. 76 (1977).

16. *See id.* at 76.

17. *See* STANLEY S. SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES 230-32 (1973).

alleged impossibility of measuring nonprofits' taxable income.[18] Bittker and Rahdert treat as insoluble conundrums such questions as: Are donations income? If not, then what expenses should be disallowed as linked to income? At what rate should charitable organizations be taxed?[19] Hansmann notes that these arguments only apply to the income tax and cannot explain the broader policy of tax exemption.[20] He adds that it would be quite easy to treat donations as income, and treat the cost of providing charitable services as business expenses.[21]

Even if one has a taste for income tax formalism, and thus believes that the key question is what the word "income" really means, this is a very plausible move. Henry Simons pointed out that gifts make recipients better off and are notionally part of their income, while also a kind of consumption expenditure by donors.[22] These arguments extend quite well to the charitable entity setting, where, absent any grounds for subsidy, taxing the organization, net of its expenses, could be thought a reasonable proxy for taxing its beneficiaries directly, despite the conceded impossibility—rather over-emphasized by Bittker and Rahdert—of taxing them at precisely the right rate.[23]

More fundamentally still, however, as Hansmann puts it in a notable early critique of the tradition of income tax formalism,

> simple analogies and metaphors . . . will not yield a satisfying answer as to whether or not we should tax the net earnings of nonprofit organizations. Rather, we must examine and judge the

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18. *See* Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation,* 85 YALE L.J. 299 (1976).

19. *See id.* at 307-14.

20. *See* Hansmann, *supra* note 5, at 58-62.

21. *See id.*

22. *See* HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 56-58 (1938). A similar argument is made in JOSEPH M. DODGE, THE LOGIC OF TAX: FEDERAL INCOME TAX THEORY AND POLICY 103 (1989). There is, of course, the well-known argument by William Andrews that gifts ought in principle to be deducted from donors' income because the donated funds are not tangibly consumed by them. *See* William D. Andrews, *Personal Deductions in an Ideal Income Tax,* 86 HARV. L. REV. 309, 348 (1972). While my objection to Andrews's argument is ultimately substantive, his view can be criticized even in more formalist terms, as relying on a rather fine and poorly motivated distinction between different voluntary uses of funds. Why is one person better-off than another (and thus deemed to have more income) simply because she has a taste for making donative transfers rather than, say, for attending theatrical or sporting events?

23. *See* Bittker & Rahdert, *supra* note 18, at 314-16. The difficulty of picking the precisely correct proxy tax rate hardly necessitates choosing a rate of zero.

> actual consequences of imposing such a tax. That is, we must consider what the world would look like both with and without such a tax, and then decide which world we like better.[24]

Thus, the case for allowing nonprofits to be tax-exempt must be based on providing a desirable subsidy, rather than simply following form or the definition of income. However, I find Hansmann's rationale for the subsidy unsatisfying, or at least tangential. He argues that, once the nonprofit form prevails, or at least is part of the mix in particular sectors of the economy, those sectors may tend to suffer from inefficient under-investment.[25] Nonprofits cannot attract equity capital by offering investors a profit share, and they ostensibly have trouble borrowing enough capital from banks and other lenders.

I have two problems with this argument. First, the nonprofit form impedes capital flows in both directions. It does not merely deter capital from flowing in, but also prevents capital from flowing out. If John and Catherine MacArthur had left their money to the automobile industry, it would have flowed right back out as soon as profitability, reflecting the optimal level of investment in that industry, declined. Because they left it to a charitable foundation, however, it will stay in the charitable sector indefinitely.

Given the two-way character of the impediments to capital flow, how do we know that nonprofit investment is too low relative to other investment? Even if new charitable needs are always arising, tax exemption may do little good on balance if it mainly locks in capital to old charitable organizations where the need for it is no longer as great.

To be sure, Hansmann agrees that this can happen, and that under-capitalization is only a possibility, not a certainty.[26] He has argued that exemption should be withdrawn where there is evidence of over-capitalization, as perhaps in the case of hospitals.[27] My conclusion is that, in general, there is no systematic reason to expect under-investment that calls for a subsidy, rather than over-investment that might perhaps call for a penalty, because of the two-way impediments to capital flow.

My second problem with the under-capitalization argument for tax exemption is that difficulty in attracting equity capital is simply one part

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24. Hansmann, *supra* note 5, at 64.

25. *See id.* at 72.

26. *See id.* at 74-75.

27. *See* Henry Hansmann, *The Changing Roles of Public, Private, and Nonprofit Enterprise in Education, Health Care, and Other Human Services*, *in* INDIVIDUAL AND SOCIAL RESPONSIBILITY: CHILD CARE, EDUCATION, MEDICAL CARE, AND LONG-TERM CARE IN AMERICA 245, 255 (Victor R. Fuchs ed., 1996).

of the trade-off between the profit and nonprofit forms of enterprise.[28] Similarly, the corporate form is superior to the partnership form in some respects but inferior in others. Where there are two alternative forms and each has the virtues of its vices and *vice versa*, it does not necessarily follow that one form ought to be subsidized by reason of one of the vices. The weakening in the nonprofit sector of the profit motive's beneficial consequences for incentives, and the fact that certain investors therefore do not want to contribute resources to it, are relevant to the optimal allocation of resources as between sectors of the economy.

Thus, in the end I believe that the under-capitalization argument adds little, if anything, to the case for exempting nonprofit organizations from tax. In this regard, Hansmann and I may not greatly disagree, because he concludes that it leaves "the justification for the exemption . . . less clear-cut than has commonly been supposed."[29] I believe that fundamentally the case for tax exemption, as well as other special tax and non-tax benefits for nonprofit organizations, must rest squarely, and more or less exclusively, on the view that the activities these organizations engage in merit public support. The basic argument, which may fail to support the benefits enjoyed by some § 501(c)(3) organizations, rests on two main claims. First, the organizations are providing public goods or engaging in activities that have positive externalities. And second, in areas where the organizations are active, decentralized private provision is either preferable—at least in part—to direct government provision, or necessary in practice to compensate for government's failure to do all that it should.

Now this may seem, no less than the under-investment argument, to emphasize only one of the organizations' two linked qualities: nonprofit form and broadly charitable purpose. Here, however, I would return to Hansmann's contract failure argument, as modified above. Taxpayers, when deciding which charitable organizations to subsidize, are in much the same position as individuals deciding where to direct their consumer or donor dollars. Thus, taxpayers are properly encouraged by the nonprofit constraint in cases where a reassuring alternative set of motivations seems plausible. This brings us full circle to an appreciation of Hansmann's seminal contribution.

28. *Cf.* Hansmann, *supra* note 5, at 74 (noting this objection).

29. *Id.* at 96.