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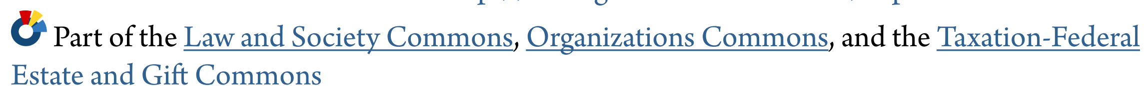
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Keep Charity Charitable

Brian Galle*

This Article responds to recent claims, most prominently by Anup Malani, Eric Posner, and Todd Henderson, that much of the work of the charitable sector should be farmed out to for-profit firms. For-profit firms are said to be more efficient because they can offer high-powered incentives to cut costs. I argue, however, that because of the high costs of monitoring and the presence of externalities, low-powered incentives are preferable for firms that produce public goods, as most charities do. Further, allowing some for-profit firms to receive charitable subsidies would raise the cost of producing those goods in government or other firms because it would diminish the "warm glow" workers enjoy from being recognized as self-sacrificing.

I. Introduction

Everyone likes charity. In the United States, a measure of our warm regard is the substantial tax support we offer to those who make cash or in-kind contributions towards charitable endeavors. Ordinarily such largesse is tied to an expectation that those who receive the funds will operate in a charitable way—that they will commit through their organization charter to forgo distribution of profits to themselves or their officers. Leading theorists of the field have maintained that charity could not long maintain its popularity, or even function, without such promises.

Recently, though, some commentators have begun to argue in favor of what might be called "for-profit" charity.[1] For example, Anup Malani and Eric Posner argue that philanthropic services could be carried on equally well by for-profit firms.[2] Pointing to the charitable efforts of Google and other money-making enterprises, they claim that the deduction is just another form of government contract for the delivery of public goods, much like payments to developers of alternative energy or private security for the Department of

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* Visiting Associate Professor, George Washington University Law School; Assistant Professor, Florida State University College of Law. I am grateful for helpful comments from and conversations with Ellen Aprill, Rob Atkinson, Bill Bratton, Joe Dodge, Daniel Halperin, Don Langevoort, Sarah Lawsky, Ben Leff, Brendan Maher, Dan Markel, Gregg Polsky, Eric Posner, Katie Pratt, David Schizer, Ted Seto, Kirk Stark, and attendees of the American Association of Law Schools Section on Scholarly Paper Award Winners, as well as of presentations at Georgetown, George Washington, Harvard, Loyola-L.A., and Prawfsfest-FSU.

1. *E.g.*, Todd Henderson & Anup Malani, *Corporate Philanthropy and the Market for Altruism*, 109 COLUM. L. REV. 571, 576 (2009); Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 93 VA. L. REV. 2017, 2019–23 (2007).

2. Malani & Posner, *supra* note 1, at 2019–23.

State.[3] They then offer a series of challenges to the conventional wisdom that these contracts can only be carried out by firms subject to the nondistribution constraint.[4] A few other commentators have joined with tentative endorsements,[5] albeit sometimes with suggestions for careful internal governance.[6]

Although these efforts are appealingly counterintuitive, this is one instance in which intuition is not only right but also determinative. As I will argue, the fact that society *perceives* an organization as charitable is a critical element of the entity's success. By opening philanthropy to potential profiteering, Malani, Posner, and their allies would dilute the power of these perceptions for every firm, including those that remain wholly charitable. And by inviting firms to reward their employees with top payouts for top "performance," they risk seriously compromising the quality of core charitable services—those that cannot be produced in a traditional profit-seeking market precisely because they cannot easily be measured. These dangers far outweigh any potential efficiency to be gained from encouraging charity to cut costs.

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3. *Id.* at 2019–21. For other recent (and largely positive) discussions of the noncharitable-charity model, see DAN PALLOTTA, UNCHARITABLE: HOW RESTRAINTS ON NONPROFITS UNDERMINE THEIR POTENTIAL 17, 116–25 (2008); Dana Brakman Reiser, *For-Profit Philanthropy*, 77 FORDHAM L. REV. 2437, 2438 (2009); James J. Fishman, *Wrong Way Corrigan and Recent Developments in the Nonprofit Landscape: A Need for New Legal Approaches*, 76 FORDHAM L. REV. 567, 598 (2007); Victor Fleischer, *Urban Entrepreneurship and the Promise of For-Profit Philanthropy*, 30 W. NEW ENG. L. REV. 93, 93 (2007); and Shruti Rana, *From Making Money Without Doing Evil to Doing Good Without Handouts: The Google.org Experiment in Philanthropy*, 3 J. BUS. & TECH. L. 87, 89 (2008). The debate is long-standing in the hospital field. *See, e.g.*, M. Gregg Bloche, *Corporate Takeover of Teaching Hospitals*, 65 S. CAL. L. REV. 1035, 1092 (1992) (arguing that for-profit hospitals can exist side-by-side with nonprofits). Also related is the rise of collaborations between nonprofits and for-profit firms; for a survey, see MARTHA MINOW, PARTNERS, NOT RIVALS: PRIVATIZATION AND THE PUBLIC GOOD 7–22 (2002).

Additionally, while this Article was in press, Jim Hines, Jill Horwitz, and Austin Nichols provided the author with a copy of their own take on for-profit charity. James R. Hines, Jr. et al., *The Attack on Nonprofit Status: A Charitable Assessment*, 108 MICH. L. REV. 1179 (2010). Their approach is similarly critical of Malani and Posner, but largely for different reasons than those I outline here. *See id.* at 1207–18 (arguing that nonprofits have some incentives to be cost-effective and possess tools to encourage employees to do so; that nonprofits do not necessarily overproduce; and that allowing for-profit charities could allow tax arbitrage).

4. Malani & Posner, *supra* note 1, at 2029–56. The nondistribution constraint is a scholarly term for the prohibition on the distribution of a firm's net revenue to any person or entity. *See infra* notes 17–22 and accompanying text. All 501(c)(3)-eligible firms must abide by the nondistribution constraint. 26 U.S.C. § 501(c)(3) (2006). This means they cannot issue stock or pay their top-tier managers with a share of the firm's revenues.

5. *See, e.g.*, Fishman, *supra* note 3, at 598 (celebrating the emergence of for-profit charities as an "encouraging development"); Brakman Reiser, *supra* note 3, at 2438 (arguing that for-profit charity challenges the assumptions of current charity law).

6. *See, e.g.*, Rana, *supra* note 3, at 89 (suggesting that Google.org "must develop innovative accountability structures to match its ambitious goals"); Dana Brakman Reiser, *Charity Law's Essentials* 34–40 (Brooklyn Law Sch. Legal Studies Paper No. 167, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1479572 (advocating group governance to reduce risks in for-profit charities).

Thus, I argue here that federal law should continue to insist that only true nonprofit organizations should be eligible to receive deductible charitable contributions. This claim also implies that firms eligible to receive the deduction cannot pay their key employees with a share of the organization's profits. I do not consider several related but distinct questions, such as whether firms that engage in charity should be exempt from the corporate income tax or whether, at a minimum, a firm should get a corporate tax deduction for the money it spends on philanthropic activity it carries out itself.

The Article proceeds in five Parts. Part II sets out in more detail the theoretical basis for government support for the charitable sector and the traditional explanation—usually associated with the work of Henry Hansmann—for why such support must be tied to a promise not to distribute profits. As Part III explains, Malani and Posner argue that this promise can be replaced with a contract with a private auditing firm. Part III claims that this proposal would increase the social costs of monitoring and inefficiently shift those costs to the charitable sector. Part IV takes issue with claims by for-profit charity proponents that the nonprofit sector is a less efficient producer of charitable services, emphasizing the role of warm glow and low-powered incentives. Part V considers briefly another alternative to traditional charity floated by Malani and Posner. Part VI concludes.

II. Theories of Subsidized Charity

Modern commentators view the deduction for charitable contributions as a federal subsidy to the recipient firms and argue that the subsidy is justified as a tool for encouraging the production of goods that would otherwise be underproduced by the private market.[7] Mostly these consist of public goods—goods whose use can be shared by many consumers and for which it

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7. *See, e.g.*, John D. Columbo, *The Marketing of Philanthropy and the Charitable Contributions Deduction: Integrating Theories for the Deduction and Tax Exemption*, 36 WAKE FOREST L. REV. 657, 698 (2001) (contending that one should view the charitable-contribution deduction as a subsidy remedying a private market failure); Mark P. Gergen, *The Case for a Charitable Contributions Deduction*, 74 VA. L. REV. 1393, 1394 (1988) (accepting that one can justify the charitable-contributions deduction as a subsidy); Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54, 68, 71 (1981) (explaining that one can justify a charitable-contribution deduction because it stimulates production of an otherwise scarce good); David E. Pozen, *Remapping the Charitable Deduction*, 39 CONN. L. REV. 531, 547 (2006) (stating that modern scholars have justified charitable-contribution deductions as a matter of public policy as a public subsidy); Daniel Shaviro, *Assessing the "Contract Failure" Explanation for Nonprofit Organizations and Their Tax-Exempt Status*, 41 N.Y.L. SCH. L. REV. 1001, 1007 (1997) (reviewing the basic argument that the charitable-contributions deduction encourages the production of a public good); *see also* OFFICE OF MGMT. & BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, ANALYTICAL PERSPECTIVES: BUDGET OF THE UNITED STATES GOVERNMENT FISCAL YEAR 2008, at 257–59 (2007), *available at* http://www.gpoaccess.gov/usbudget/fy08/pdf/spec.pdf (arguing that the federal government should provide tax incentives for charitable giving).

would be relatively difficult for the producer to exclude users.[8] Because of these features, there is a private-market failure in the production of public goods.[9] Individuals have a strong incentive to free ride on others' consumption, and thus it is difficult for any producer to sell the good at a profit.[10] Even if some goods can be sold, the market will probably produce less than the socially optimal amount of the good.[11]

One classic example of a public good is the fireworks display.[12] Once I pay for the show, all of my neighbors can camp out and enjoy the evening without paying; therefore, no one of us has much reason to be the one who pays. Even if I am willing to pay, I may purchase fewer fireworks than would satisfy everyone because I am indifferent to others' consumption. However, if there is a subsidy for purchasing fireworks, I will buy more of them due to both the income and substitution effects of the subsidy. Ideally, the subsidy amount would be set so that I will purchase exactly the amount of fireworks that would maximize every viewer's preferences.[13]

This public-goods explanation for the charitable-contribution deduction accords well with federal law. Current law generally conditions eligibility for deductible contributions on private-market failures.[14] The IRS can audit

8. On the general theory of public goods, see RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 42–48 (5th ed. 1989).

9. *Id.* at 44–45; *see also* Gergen, *supra* note 7, at 1397–98 ("Left to its own devices without a tax subsidy, [private charity] may not be able to overcome its freerider problems to provide the appropriate amount of the good."); Hansmann, *supra* note 7, at 72 (arguing that without incentives charitable contributions to nonprofits are below socially optimal levels).

10. MUSGRAVE & MUSGRAVE, *supra* note 8, at 44.

11. Hansmann, *supra* note 7, at 72.

12. *See, e.g.*, JONATHAN GRUBER, PUBLIC FINANCE AND PUBLIC POLICY 184–85 (2d ed. 2006) (explaining that a fireworks display is a public good because it can be shared by many consumers and it is difficult to exclude consumers from the display).

13. Although I refer throughout this Article to "public goods," the reader should understand that the discussion for the most part also applies more generally to any private good with a significant positive externality attached. *See id.* at 171 ("It is helpful to think about a public good as one with a large positive externality."); MUSGRAVE & MUSGRAVE, *supra* note 8, at 49–50 (noting that the two are largely equivalent, albeit that a smaller subsidy is needed to produce private goods with positive externalities).

Similarly, in some cases, some of what I refer to as public goods might more precisely be described as "club goods" because in theory they could be "fenced" and made accessible only to "members." Again, some club goods may also produce externalities for nonmembers, such as an exclusive park with historic social significance. Here, again, there will be underprovision of the nonprivate aspects of consumption; the club will not necessarily use the park in a way that is consistent with historic preservation. For a survey of other arguments for government production of potential club goods, see Amnon Lehavi, *Property Rights and Local Public Goods: Toward a Better Future for Urban Communities*, 36 URB. LAW. 1, 16–24 (2004).

14. *See* BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS § 4.10, at 103–08 (9th ed. 2007) (explaining that the IRS may deny eligibility on the basis that an "organization's operation is similar to a commercial enterprise operated for profit" and providing examples).

firms and revoke exemptions or impose excise taxes on firms and managers if they produce only private goods or distribute profits.[15]

As Henry Hansmann argues, this justification for the deduction also implies that beneficiaries of the deduction must likely be limited to nonprofit organizations.[16] A nonprofit, in Hansmann's formulation, is one that is subject to the "nondistribution constraint": it can make a profit, but it must use these profits for internal development rather than distributing them to investors or managers.[17] The logic is that donors cannot easily judge the quality of public goods, especially where those goods are delivered to someone other than the donor.[18] As a result, it would be easy for managers of the firm to divert donations to their own personal benefit.[19] Knowing this, donors will not give to the firm.[20] Hansmann calls this phenomenon "contract failure."[21] In response, the firm voluntarily takes on the nondistribution constraint so that donors know that their giving will not be wasted.[22]

Several factors contribute to the difficulty of monitoring the quality of public goods and hence to contract failure. First, many public goods are inherently ineffable or controversially defined.[23] For instance, donating to a soup kitchen might contribute to a more just society. While we can easily

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15. *See* 26 U.S.C. §§ 4941–4942, 4958 (2006) (authorizing the IRS to revoke exemptions); IRS, PUB. NO. 4221-PC, COMPLIANCE GUIDE FOR 501(C)(3) PUBLIC CHARITIES 2–3 (2009), *available at* http://www.irs.gov/pub/irs-pdf/p4221pc.pdf (outlining IRS enforcement procedures for charitable entities).

16. *See* Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 623 (1981) (arguing that government subsidy to charitable organizations justifies federal oversight of nonprofit status); *see also* Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. REV. 501, 617–18 (1990) (explaining that under Hansmann's analysis "only nonprofit firms address the kinds of contract failure and experience the kinds of capital constraints that warrant" a subsidy).

17. Hansmann, *supra* note 16, at 501; Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980).

18. Hansmann, *supra* note 16, at 506; *see also* Atkinson, *supra* note 16, at 572 (arguing that managers of a for-profit firm would need to provide an "altruistic investor" with an enforceable commitment "that they will use the imputed return on her donated capital to subsidize consumption").

19. Hansmann, *supra* note 7, at 68–70; *cf.* Kenneth J. Arrow, *Uncertainty and the Welfare Economics of Medical Care*, 53 AM. ECON. REV. 941, 964–65 (1963) (suggesting that the profit-making aspect of hospitals is relatively unimportant because doctors' commitment to professionalism helps to assure patients unable to measure quality that the doctors will prioritize care over profits).

20. Hansmann, *supra* note 7, at 69–70.

21. *Id.* at 69; Hansmann, *supra* note 16, at 506–07.

22. Hansmann, *supra* note 16, at 507; Malani & Posner, *supra* note 1, at 2033–34; *see also* Susan Rose-Ackerman, *Altruism, Nonprofits, and Economic Theory*, 34 J. ECON. LIT. 701, 716 (1996) ("[D]onors may be willing to donate only to nonprofit institutions. Given the difficulty of monitoring charitable work, donors may fear that for-profit firms will convert gifts into profits for the owners.").

23. *See* John D. Donahue, *Market-Based Governance and the Architecture of Accountability*, *in* MARKET-BASED GOVERNANCE 1, 5–6 (John D. Donahue & Joseph S. Nye, Jr. eds., 2002) (describing the difficulties of arriving at universal definitions of success in areas of public interest, such as schools and taxes).

measure the calories in the soup or the number of persons served, it remains difficult to say to what degree those outcomes have helped effect justice.

More pragmatically, as Hansmann observes, many public goods involve a separation between purchaser and beneficiary.[24] The donor to a soup kitchen is a purchaser of the public good of social justice, but it is the kitchen's clients who are direct recipients of the services. Accordingly, it can be hard for the purchaser to monitor the quality of the services provided. I would add that the monitoring problem is especially acute in the common case of public goods with large gaps of time or distance between donor and direct beneficiary. To take one example, education directly benefits students, but the public-good component of education is that it produces a more informed electorate, a better trained workforce, and perhaps a more just society.[25] All of these gains arise many years after a donor contributes and often in places far removed from the school itself. Thus, donors get very little meaningful short-term feedback on the quality of their donation. Even if feedback were available, each individual donor has strong incentives to free ride on the monitoring efforts of others, since monitoring by any one provides benefits to all.

In short, government provides subsidies for charity as a way to encourage production of public goods, and these subsidies are reserved for nonprofit organizations because otherwise donors could not know whether their funds—and the government's dollars—were being diverted to private profit.

III. Monitoring

Malani and Posner begin their defense of for-profit charity by disputing Hansmann's link between contract failure and the need for a nondistribution constraint.[26] They acknowledge the possibility of contract failure but suggest that instead of taking the nonprofit form, each firm could simply "promise donors, by contract, that it will not distribute profits."[27] The firm can guarantee compliance by hiring "an auditor such as PricewaterhouseCoopers to police the contract."[28] In the event of default, the donor "could sue the entrepreneur for breach of contract."[29] The duo acknowledges that this arrangement creates costs for donors, who must monitor and sue the firm for

24. Hansmann, *supra* note 17, at 846–47.

25. GRUBER, *supra* note 12, at 287–89.

26. Malani & Posner, *supra* note 1, at 2035.

27. *Id.* at 2035–36.

28. *Id.* at 2036; *see also* Michael Krashinsky, *Transaction Costs and a Theory of the Nonprofit Organization*, *in* THE ECONOMICS OF NONPROFIT INSTITUTIONS: STUDIES IN STRUCTURE AND POLICY 114, 117 (Susan Rose-Ackerman ed., 1986) (suggesting that warranties and middlemen are alternatives to the nondistribution constraint); Geoffrey A. Manne, *Agency Costs and the Oversight of Charitable Organizations*, 1999 WIS. L. REV. 227, 229 (offering "creation of private, for-profit monitoring companies" as a solution to failures in nonprofit monitoring).

29. Malani & Posner, *supra* note 1, at 2036.

noncompliance.[30] But, they say, there are also costs of government-enforced compliance, and it is not clear which is cheaper from a societal perspective.[31]

A. *Distribution of Monitoring Costs*

This analysis overlooks the distribution of the costs of compliance. The expense of government enforcement is borne by all taxpayers, while the burden of private auditing and bringing contract claims would fall on the firm and its stakeholders.[32] Thus, public enforcement is an additional subsidy for the charitable form.[33] As a practical matter, this subsidy may be crucial for small charities, where the costs of private guarantees might represent a large portion of the annual budget. Also, if each additional firm generates its own contracting and monitoring costs, private monitoring would tend to encourage charities to consolidate rather than specialize, distorting what would otherwise be the optimal choice of policy focus. And donors would change their behavior to give more money to a few firms rather than spreading their largesse more widely, thereby threatening the health of small charities.

On a more theoretical level, the costs of monitoring charity should be borne by the public because that mirrors the distribution of costs when public goods are provided by government. Shifting these costs onto the firms would place them at a disadvantage relative to the government sector. The problem with this arrangement is that, as I argue elsewhere, legal rules should leave taxpayers indifferent between purchasing public goods from government or from charity so that the two can compete on the basis of quality alone.[34]

B. *The Mixed-Firm Problem*

In addition to the distribution problem, mixing charitable and noncharitable enterprises in the same firm increases monitoring costs.[35]

30. *Id.* at 2037–38.

31. *Id.* at 2038.

32. *Cf.* Atkinson, *supra* note 16, at 519 (observing that enforcing the nondistribution constraint is costly for monitors). At the state level, attorneys general are the main enforcers of nonprofit firm charters. *See* James J. Fishman, *Improving Charitable Accountability*, 62 MD. L. REV. 218, 259–65 (2003) (tracing the past and present role of attorneys general in enforcing accountability in the nonprofit sector).

33. To the extent that the burden of higher monitoring costs is borne by the recipients of charity, such as through lower total expenditures, this shift in distribution might be the equivalent of a regressive tax. That is, if beneficiaries are poorer on average than the average taxpayer, the shift in incidence redirects wealth from poor to rich. In most economic analysis, that shift would reduce overall social welfare because of the diminishing marginal utility of wealth: money is more valuable to those who have less of it. MUSGRAVE & MUSGRAVE, *supra* note 7, at 83–85.

34. Brian Galle, The Role of Charity in a Federal System 77 (Dec. 1, 2009) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1473107. Making the consumption of public goods more costly through charity would also make lobbying for government provision relatively more attractive, which is a poor outcome if we think that charity is justified as a cure for some of the problems of public choice theory. *Id.* at 27–33.

35. Malani & Posner, *supra* note 1, at 2052–53.

Malani and Posner acknowledge that expanding eligibility to for-profits may increase the burden on the IRS to screen applicants, but they claim that this problem can be solved by charging application fees or imposing penalties on "abusive" applicants.[36] These user charges, like private monitoring, are simply another mechanism for shifting costs onto the charitable provider and are subject to the same distributional problems I have just mentioned.

More problematically, the overall social cost of monitoring is higher in for-profit charity, regardless of distribution, because mixed-purpose organizations present extra difficulties not present in pure charitable entities. As David Schizer and Victor Fleischer have pointed out, making for-profit firms eligible for contribution deductions would require the IRS to identify worthy charitable functions with considerably more specificity than it does today.[37] Consider scientific journals. A journal looks a lot like a for-profit magazine, but under current law it can establish that it is a charity by showing a general editorial policy of selecting articles on the basis of scientific merit rather than commercial appeal.[38] But under the Malani and Posner proposal, a for-profit magazine like *Popular Mechanics* could accept deductible donations and use them to fund the publication of boring but scientifically sound articles in its otherwise profitable magazine.[39] We then would presumably have to weigh, article by article, whether each piece was selected on the basis of scientific merit. The costs to both government and charity of these endless determinations would increase many times over.

Malani and Posner might argue in response that this example is a *reductio ad absurdum* and that what they have in mind instead is something like a for-profit company that operates a charitable branch. Then the activities of the subdivision can be monitored at a general level, like any other charity. But that situation, if anything, is even worse from a monitoring perspective. Related businesses can easily pass value to each other in ways that are extremely difficult to observe.[40] Organizations can share staff, space,

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36. *Id.* at 2052–54.

37. *See* David M. Schizer, *Subsidizing Charitable Contributions: Incentives, Information and the Private Pursuit of Public Goals*, 62 TAX L. REV. 221, 254 (2009) (advocating subsidizing "for-profit" charities only if the definition of eligible activities is tightened considerably); Victor Fleischer, *"For Profit Charity": Not Quite Ready for Prime Time*, 93 VA. L. REV. IN BRIEF 231, 231–32 (2008), http://www.virginialawreview.org/inbrief/2008/01/21/fleischer.pdf (noting that if the nondistribution constraint were removed, the broad language of § 501(c)(3) would open the floodgates for companies to claim to be charities).

38. *See* HOPKINS, *supra* note 14, § 8.5, at 292 (describing rules under which entities can qualify for 501(c)(3) status through their "advancement of education or science").

39. It is useful to distinguish the deduction the firm takes for its own costs from the deduction outsiders could receive for purchasing charitable services from the firm. The firm itself can always take a deduction for its ordinary and necessary expenses. *See* Fleischer, *supra* note 37, at 232–33 (pointing out that a corporation may use the losses from an unprofitable subsidiary—such as a charity—to offset the taxable income of a profitable subsidiary). So the key issue here is really whether the firm's "customers" can take a deduction.

40. *See* Brakman Reiser, *supra* note 3, at 2466 (acknowledging this concern about for-profit charities); Hines et al., *supra* note 3, at 1212 (making this point with regard to donor efforts to

mailing lists, phone trees, and good will.[41] While staff time can be logged, logs alone cannot account for the economies of scale and scope that come with working for the two organizations in tandem. A regulatory system capable of detecting these transfers would be complex and likely involve much effort spent resolving disputes over close cases.[42]

Transfers from a charitable branch to a corporate parent merit this close scrutiny because they raise the threat of significant distortions. If deductible dollars can be leveraged by a for-profit parent entity, it will gain a cost advantage over its competitors.[43] Therefore, the hybrid form would encourage the creation of plausible but largely fake charities or philanthropic operations whose benefits to the public would be small relative to the gains to the firm. The possibility of cross-subsidies would also distort investors' choice of efficient firm organization, encouraging entrepreneurs to bring charity in-house rather than simply supporting a variety of outside philanthropy. Or, again, society could spend large sums policing the boundaries. Either way, the for-profit charity is costlier than the pure charity.

Henderson and Malani turn this argument on its head, claiming economies of scope make charity more efficient in a for-profit firm, with the charity benefiting from expenditures on the for-profit side.[44] But this possibility highlights the difficulty of monitoring mixed-purpose firms. Any firm would be able to offer the Henderson and Malani reasoning as cover for its use of deductible dollars to build up its for-profit infrastructure, leaving regulators with few tools to determine when deductions have been put to bad purposes. And whether waste or efficiency predominates will depend in large part on the efficacy of enforcement efforts—if enforcement is ineffective, then competition will oblige virtually every firm to have a captive charity supplying it with cross-subsidies.

IV. Cost and Quality

The effects of mixing the profit motive with charity also undercut Malani and Posner's claim that nonprofits are less efficient. They suggest

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monitor firms); Schizer, *supra* note 37, at 255 n.82 ("[T]ransfer pricing is already quite malleable, and without separate legal entities it becomes even harder to monitor.").

41. *See* Atkinson, *supra* note 16, at 570 (describing the cost-lowering benefits of horizontally and vertically integrating for-profit and nonprofit organizations).

42. For a sense of the difficulties here, consider the law of joint ventures between nonprofit and for-profit hospitals, which covers more than one-hundred pages in a leading treatise. MICHAEL I. SANDERS, JOINT VENTURES INVOLVING TAX-EXEMPT ORGANIZATIONS 491–609 (3d ed. 2007).

43. *Cf.* Hansmann, *supra* note 17, at 883 (noting that the deduction "gives a financial advantage to [firms] that qualify for it"). This is already a serious problem with many current collaborations between nonprofits and for-profits, as with hospitals and affiliated for-profit care centers owned by physicians who practice at the hospital. The doctors can refer patients from the hospital to their own businesses, in effect leveraging the good will and contacts of the hospital to their own gain. Council on Ethical & Judicial Affairs, Am. Med. Ass'n, *Conflicts of Interest: Physician Ownership of Medical Facilities*, 267 J. AM. MED. ASS'N 2366, 2366 (1992).

44. Henderson & Malani, *supra* note 1, at 590–93.

that for-profit firms will be more skilled at keeping costs low,[45] that nonaltruistic managers may work in nonprofits and enjoy leisure rather than high profits,[46] and that even altruistic managers face little competition and so have little incentive to perform effectively.[47] Relatedly, Henderson and Malani argue that for-profits offer lower agency costs than charities.[48] These claims all overlook the possible effect of the nonprofit form itself on managers' behavior and neglect the existence of rivalries between nonprofits and government.

A. *Warm Glow Effects*

One distinctive feature of charity is the good feeling, or "warm glow," that some people get from participating in it.[49] Warm glow can derive from moral satisfaction, social approbation, or simply the status signal of being able to spend generously.[50] Empirical studies suggest that warm glow is a significant motivation for many charitable gifts.[51]

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45. Malani & Posner, *supra* note 1, at 2048–50; *see also* Myron J. Roomkin & Burton A. Weisbrod, *Managerial Compensation and Incentives in For-Profit and Nonprofit Hospitals*, 15 J.L. ECON. & ORG. 750, 752–53 (1999) (noting that nonprofits may pay higher base salaries than for-profits to compensate for the lack of profit-based compensation).

46. Malani & Posner, *supra* note 1, at 2034–35; *see also* Marco A. Castaneda et al., *Competition, Contractibility, and the Market for Donors to Nonprofits*, 24 J.L. ECON. & ORG. 215, 222 (2007) (discussing the ways that promotional expenditures by nonprofits may provide utility to donors and asserting that increased promotional expenditures lead to increased donations); Richard A. Posner, *What Do Judges and Justices Maximize? (The Same Thing Everybody Else Does)*, 3 SUP. CT. ECON. REV. 1, 8–9 (1993) (positing that people who choose to work in the nonprofit sector may willingly trade income for increased job security or other sources of nonmonetary utility).

47. Malani & Posner, *supra* note 1, at 2054–56.

48. Henderson & Malani, *supra* note 1, at 598–600. Henderson and Malani also offer other similar arguments that warrant less discussion. For example, they suggest that for-profit firms acquire unique "leverage" over charities' managers by collating many different donations. *Id.* at 599. In the charitable literature, this is a function commonly attributed to foundations. *See* Atkinson, *supra* note 16, at 583–84 (arguing that sizable private foundations may have adequate leverage to achieve economical deals with for-profit suppliers that smaller donors could not). They also point to the greater societal scrutiny of for-profit firms generally. Henderson & Malani, *supra* note 1, at 599–600. But they offer no reason to suspect that this scrutiny is aimed at the philanthropic activities of firms—as opposed to, say, the other, vastly larger, activities of the firm. *Cf. id.* at 622 (noting that the average firm contributes 1.5% of profits to charity).

49. *See* B. Douglas Bernheim & Antonio Rangel, *Behavioral Public Economics: Welfare and Policy Analysis with Nonstandard Decision-Makers*, *in* BEHAVIORAL ECONOMICS AND ITS APPLICATIONS 7, 62–65 (Peter Diamond & Hannu Vartiainen eds., 2007) (evaluating the difficulty of quantifying the effects of warm glow); Rose-Ackerman, *supra* note 22, at 712–13 (observing that donors may donate in order to feel a warm glow that is separate from and in excess of their desire that others benefit from their contribution).

50. *See* James Andreoni, *Impure Altruism and Donations to Public Goods: A Theory of Warm-Glow Giving*, 100 ECON. J. 464, 473–74 (1990) (predicting that, all other things being equal, donors prefer a transfer of income that will result in the most warm glow); Kenneth J. Arrow, *Gifts and Exchanges*, 1 PHIL. & PUB. AFF. 343, 348–49 (1972) (describing blood donors as being partially motivated by the moral satisfaction gleaned from having individually contributed to the welfare of society); Bernheim & Rangel, *supra* note 49, at 62–65 (providing a partial list of "warm-glow mechanisms," including responses to perceived public perception of the donor's behavior and

Warm glow changes the incentives of a charity's employees. Just as giving to charity produces a warm glow, so too may working for one. We should expect the possibility of this noncash compensation to lower the actual cost of wages for nonprofits.[52] In effect, the employees are making donations of the difference between their salary and the market salary for someone of their talents and realizing the psychic rewards from the gift. Note that the value here is not simply the warm glow from producing the good, as Malani and Posner assume,[53] but also the warm glow from producing it *at a charity*, where peers will know that the employee is making a sacrifice.[54] Even if working in the charity division of a for-profit created some kind of comparable glow, any cost savings would quickly be competed away. Because the lower wages offer a competitive price advantage, new firms would enter to capture the available surplus.[55] Each additional firm would increase the demand for warm glow workers until the point at which enough firms had entered to bid up the price to the market salary.[56]

The warm glow point goes at least some way towards answering all three of the Malani and Posner criticisms. Obviously, firms with lower labor

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positive and negative reciprocity); Peter Diamond, *Optimal Tax Treatment of Private Contributions for Public Goods with and Without Warm Glow Preferences*, 90 J. PUB. ECON. 897, 917 (2006) (arguing that warm glow is partially a result of the decrease in social pressure to donate); Amihai Glazer & Kai A. Konrad, *A Signaling Explanation for Charity*, 86 AM. ECON. REV. 1019, 1019–21 (1996) (presenting evidence for the proposition that altruism is often motivated by a desire to demonstrate wealth); Rose-Ackerman, *supra* note 22, at 712–13 (pointing out that the satisfaction people derive from philanthropy stems from both seeing positive changes in the community and from the warm glow associated with giving).

51. *See, e.g.*, Bruce R. Kingma & Robert McClelland, *Public Radio Stations Are Really, Really Not Public Goods: Charitable Contributions and Impure Altruism*, 66 ANNALS PUB. & COOP. ECON. 65, 66–67 (1995) (citing studies showing that impure altruism, including warm glow, explains some charitable giving); John Peloza & Piers Steel, *The Price Elasticities of Charitable Contributions: A Meta-analysis*, 24 J. PUB. POL'Y & MKTG. 260, 265 & tbl.1 (2005) (compiling studies and concluding that tax deductions are treasury efficient, suggesting that noneconomic motivations are involved in charitable giving).

52. *See* Bruce R. Kingma, *Public Good Theories of the Non-profit Sector: Weisbrod Revisited*, 82 VOLUNTAS 135, 142 (1997) (arguing that employee control over the organization's mission and services explains empirical evidence of lower wages in the nonprofit sector); Roomkin & Weisbrod, *supra* note 45, at 753–54 (noting studies finding higher wages in for-profits but suggesting explanations other than a warm glow offset in complex industries); Shaviro, *supra* note 7, at 1003 (suggesting that certain fields are more likely to benefit from warm glow in the potential labor pool). Professor Malani has acknowledged this possibility in his other work. *See* Henderson & Malani, *supra* note 1, at 583–84, 619 (acknowledging that workers would be likely to accept lower wages in exchange for jobs that provide warm glow).

53. *See* Malani & Posner, *supra* note 1, at 2047–48 ("[A]ltruists obtain additional value from producing public goods . . . .").

54. *See* Glazer & Konrad, *supra* note 50, at 1020–21 (explaining that donors donate to charity at least partly for signaling purposes rather than simply to obtain satisfaction unrelated to status).

55. *See* WILLIAM J. BAUMOL ET AL., CONTESTABLE MARKETS AND THE THEORY OF INDUSTRY STRUCTURE 192 (1988) (asserting that monopoly rents permit new entrants).

56. Nonprofit entrepreneurs would not enter a field simply to leverage submarket wages into profits because by definition they cannot extract profit. Thus, it is more likely that nonprofit entrepreneurs launch their endeavors to meet unmet social needs or to find employment, and accordingly they would not be attracted by low wages.

costs will tend to have lower total costs, although some charities may still initially lack the skill to hold costs down. Malani and Posner state that there is no competitive pressure to force nonprofit managers to learn to cut costs, but they assume that the only source of competitive pressure is the threat of job loss.[57] Yet managers who are motivated by the desire to fulfill their mission will have reason to minimize costs that are unrelated to the mission.[58] In a firm that pays below market salary, managers will self-select to those who in fact receive warm glow from their work.[59] Likewise, to the extent that they are self-selected for commitment, nonprofit managers are less likely to shirk on quality.[60]

Mixing charitable enterprise with the for-profit form would undermine the benefits of warm glow for everyone.[61] A portion of warm glow likely

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57. Malani & Posner, *supra* note 1, at 2055–56. Empirical evidence also suggests that competition for donor funds at least partially disciplines nonprofit firms. *See* Castaneda et al., *supra* note 46, at 245 (concluding that competition, along with contracting, reduces reported administrative expenses).

58. *See* Krashinsky, *supra* note 28, at 117; Rose-Ackerman, *supra* note 22, at 719 (arguing that ideological commitment plays an important role in overcoming inefficient incentives within professions); George G. Triantis, *Organizations as Internal Capital Markets: The Legal Boundaries of Firms, Collateral, and Trusts in Commercial and Charitable Enterprises*, 117 HARV. L. REV. 1102, 1147 (2004) (asserting that informational asymmetry between donors and managers creates an obstacle in fundraising situations). On the other hand, prestige motivations introduce another possible agency cost, as Triantis argues. *Id.* at 1116–17.

59. *See* Kingma, *supra* note 52, at 142 (opining that employees and entrepreneurs in nonprofits prefer serving the public good to increased wages and social output); Rose-Ackerman, *supra* note 22, at 719 (noting that ideologue founders seek employees that share their ideals and vision). *But see* Linda Sugin, *Resisting the Corporatization of Nonprofit Governance: Transforming Obedience into Fidelity*, 76 FORDHAM L. REV. 893, 907 (2007) (noting that low pay may also simply attract those who are less skilled). I assume, in contrast to Professor Sugin's view, that firms can screen for employee quality. Whether there are likely to be sufficient numbers of skilled employees is a subject I return to shortly.

It could be argued that some individuals will also choose nonprofit employment as a way to gain leisure time in exchange for a lower salary. For that to be true, the employee would have to expect that the firm's principals are unable to monitor her effectively. That is plausible. *See* Hansmann, *supra* note 16, at 507, 568 (observing that patrons of nonprofits have little authority to oversee the management and work of the nonprofit). On the other hand, coworkers can monitor their fellow employees' efforts more easily. *See* Hansmann, *supra* note 17, at 876 (remarking that normative constraints operate better in certain nonprofits than in others). If coworkers are motivated by their mission or resent slacking in others, this monitoring may have some bite. *Cf.* Mark Barenberg, *Democracy and Domination in the Law of Workplace Cooperation: From Bureaucratic to Flexible Production*, 94 COLUM. L. REV. 753, 881–903 (1994) (describing self-monitoring workplaces). As a result, it would seem that those who value leisure above salary could obtain the same tradeoff between salary and leisure without the risk of sanction simply by taking a part-time job.

60. *See* Hansmann, *supra* note 17, at 876 (noting that nonprofits are likely to choose as managers those whose ideals match the firm's).

61. The argument here is similar to, but distinct from, Bruno Frey's point that extrinsic motivations may sometimes "crowd out" people's internal motivations to do good. Bruno Frey, *A Constitution for Knaves Crowds Out Civic Virtues*, 107 ECON. J. 1043, 1044–47 (1997). Like Frey, I argue that an inaptly designed subsidy may actually reduce incentives to engage in the subsidized behavior, but the mechanism I suggest is not the same as the psychological factors he surveys, *id.* at 1045–46.

derives from donors' ability to signal their own largesse.[62] To gain this benefit, others must be able to perceive the gift. Thus, if casual outside observers cannot be sure whether a given worker is toiling for a nonprofit or for a money-making enterprise, the social rewards of working for any charity are lower. Malani and Posner's proposal would create this confusion by making it unclear whether any given firm producing charitable services was paying its employees a share of profits.[63]

As a result, the mixed form lowers nonmonetary rewards not only at the for-profit but also at all enterprises carrying out a charitable mission.[64] Charities then will be obliged to pay higher wages and to screen and monitor more aggressively for self-dealing. Thus, even if for-profits are more efficient at their own work, encouraging for-profits to do charity could on net make the charitable sector as a whole less efficient.

Malani and Posner recognize to some extent the benefit of relying on employees who are committed to their mission, but they argue that the labor market may not supply enough of those individuals.[65] Their solution, though, actually cools the glow, reducing the number of available workers motivated by warm glow. The status quo, in which government providers of public goods constrain inefficient charities, is preferable. As the supply of warm-glow-driven workers dries up and costs in the nonprofit sector rise, government will become a more attractive alternative for donors and taxpayers choosing their service provider. This competition will help to drive highly inefficient nonprofits out of business. In addition, there is little danger that outside observers will confuse working for a charity with working for city or state government, so that dividing the provision of public goods solely between those two sectors maintains the purity of the signal sent by nonprofit employment and the power of warm glow motivation.

B. The Advantage of Low-Powered Incentives

Next, the fact that the nondistribution constraint largely bars any form of high-powered incentives for nonprofit employees to perform is a feature, not a bug, of the sector.[66] Typically, owners of for-profit firms align their

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62. *See* Glazer & Konrad, *supra* note 50, at 1020–21 (stating that, according to empirical data, donations serve as a means to signal income to those who do not view the individual's consumption of luxury goods).

63. *See* Malani & Posner, *supra* note 1, at 2065 (suggesting that the IRS should permit nonprofit managers to receive incentive pay correlated to profits, revenues, or the operating costs of the organizations).

64. *Cf.* Hansmann, *supra* note 16, at 524 (suggesting that changed norms in some parts of the nonprofit sector could "undermine the collective morality of that sector as a whole").

65. Malani & Posner, *supra* note 1, at 2047–49.

66. Hines, Horwitz, and Nichols argue that nonprofits can probably lawfully offer their employees performance incentives. Hines et al., *supra* note 3, at 1193–97. They acknowledge, though, that there is no clear guidance on the question, *id.*, and that anecdotal evidence suggests most firms are unwilling to push to find the edge of the legal limits, *id.* at 1196–97. Also, there is little even in their careful unpacking of the applicable law to suggest that firms can pay managers

employee incentives with their own by offering pay structures that have a very powerful influence on the behavior of their employees.[67] Giving the employees a share of profits or a general equity stake in the firm is the quintessential example of these high-powered incentives: employees now care more about ownership's interests because they are also owners.[68] In contrast, nonprofits and government are limited to offering "low-powered" incentives—such as performance bonuses, promotions, and job security—that have a somewhat weaker influence on behavior.[69] Critics of government have long argued that this weak incentive structure is what allows the private sector to outperform government.[70]

1. Measurement Problems.—High-powered incentives, like high-powered explosives, are dangerous if left in the wrong place.[71] As has been widely recognized, in the recent financial crisis firms offered their managers powerful incentives to take on massive amounts of risk.[72] And the managers followed their self-interest, to our collective sorrow.[73] Powerful incentives,

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for cutting costs, which I will argue here are the most problematic incentives (and the incentives of greatest interest to Malani and Posner). In any event, my analysis suggests that any strong expansion towards permitting powerful incentives in nonprofit compensation would be a mistake.

67. *See* Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 761–63 (2002); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 328 (1976) (both discussing use of employee compensation structures as tools for controlling employee incentives).

68. *See* Bebchuk et al., *supra* note 67, at 775 (describing stock options as a crucial means of encouraging executives to maximize firm performance and shareholder value); David Weisbach, *Tax Expenditures, Principal-Agent Problems, and Redundancy*, 84 WASH. U. L. REV. 1823, 1846–47 (2006) (discussing how assigning risk from the principal to the agent can alter agents' incentives).

69. *See* Weisbach, *supra* note 68, at 1846–48 (asserting that without large cash incentives, incentives given to public servants are considered low-powered and thus less effective).

70. *See, e.g.*, Armen A. Alchian & Reuben A. Kessel, *Competition, Monopoly, and the Pursuit of Money*, *in* ASPECTS OF LABOR ECONOMICS 157, 166 (Nat'l Bureau of Econ. Research ed., 1962) (noting that a public utility does not possess the ability to distribute wealth as dividends to its owners and thus can only offer weak incentives).

71. *See* EDWARD E. LAWLER III, STRATEGIC PAY 58 (1990) (stating that when used incorrectly, incentive systems enable many employees to spend their energies outsmarting the system rather than increasing the value of the products); Triantis, *supra* note 58, at 1114 (explaining that shifting risk to managers may increase risk-averse decision making, resulting in inefficient allocation of capital).

72. *See, e.g.*, John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 729–30 (2009) (explaining that because of the transition in compensation from cash to stock options, senior management undertook riskier strategies); Jeff N. Gordon, *"Say on Pay": Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-In*, 46 HARV. J. ON LEGIS. 323, 363–64 (2009) (remarking that the compensation structures of senior executives that were based on high-powered incentives enabled excessive risk taking).

73. This is not to say that managerial incentives were nearly the whole story. *See, e.g.*, INT'L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: FINANCIAL STRESS AND DELEVERAGING 14 (2008), *available at* http://www.imf.org/external/pubs/ft/gfsr/2008/02/pdf/text.pdf (pointing to the U.S. housing market); Coffee & Sale, *supra* note 72, at 731–49 (exploring

in other words, are risky. If incentive targets are misaligned—for example, where management cannot define in advance what behavior will maximize outputs—then the firm can expend large resources paying out bonuses for actions that can actually hurt the firm, or, at best, waste both the firm resources sunk into incentives and the manager time spent pursuing them.[74]

As difficult as designing an incentive structure can be in a for-profit firm, nonprofits, under my account of the nonprofit sector, present special problems because of the difficulty of measuring nonprofits' outputs. Many commentators, from Hansmann on, have noted that public goods are hard to value and that this creates a dilemma for monitoring efforts.[75] It follows that a high-powered incentive structure would be unlikely to produce manager behavior that matches the firm's goals. Jacob and Levitt, for instance, have documented how rewards for teachers based on test results lead teachers to "teach to the test," or to just give their students the answers.[76] Acemoglu and his coauthors argue more generally that when "bad" motivations such as teaching to the test dominate the positive rewards of high-powered incentives, the firm would be better off providing only low-powered incentives.[77] Putting these points together, firms that produce public goods should not use high-powered incentives because the risks of mismeasurement, waste, and bad incentives are prohibitively high.[78]

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regulatory failure, the structure of the investment-banking industry, moral hazard by mortgage originators, and behavior by bank executives as contributing possibilities).

74. *See* George P. Baker, *Incentive Contracts and Performance Measurement*, 100 J. POL. ECON. 598, 599–600, 606 (1992) (asserting that if the agent's actions do not directly conform to the principal's objectives, there will inevitably be inefficiencies).

75. *E.g.*, Hansmann, *supra* note 17, at 898 n.160; Manne, *supra* note 28, at 239; Posner, *supra* note 46, at 10; Triantis, *supra* note 58, at 1147; *see also* William W. Bratton & Joseph A. McCahery, *The New Economics of Jurisdictional Competition: Devolutionary Federalism in a Second-Best World*, 86 GEO. L.J. 201, 236 (1997) (arguing that the evaluation problem prevents meaningful interjurisdictional competition based on quality of outputs).

76. Brian A. Jacob & Steven D. Levitt, *Rotten Apples: An Investigation of the Prevalence and Predictors of Teacher Cheating*, 118 Q.J. ECON. 843, 844 (2003). Similarly, an earlier study of educational incentives found that measuring student outputs led to "cream skimming": more aggressive recruitment of students who would score high on the evaluation tool without any additional schooling, greatly reducing the usefulness of the money spent on training. Michael Cragg, *Performance Incentives in the Public Sector: Evidence from the Job Training Partnership Act*, 13 J.L. ECON. & ORG. 147, 161–62 (1997).

77. Daron Acemoglu et al., *Incentives in Markets, Firms, and Governments*, 24 J.L. ECON. & ORG. 273, 274 (2008); *see also* Oliver E. Williamson, *Public and Private Bureaucracies: A Transaction Cost Economics Perspective*, 15 J.L. ECON. & ORG. 306, 325 (1999) ("[A]dded incentive intensity undermines probity."). David Weisbach offers a related point, building on Holmstrom and Milgrom and others. Weisbach points out that if some but not all of an agent's outputs can be measured and the agent is offered high-powered incentives, the agent will tend to overproduce the measurable outputs. Weisbach, *supra* note 68, at 1848–49 (citing AVINASH K. DIXIT, THE MAKING OF ECONOMIC POLICY 96 (1996); Bengt Holmstrom & Paul Milgrom, *Multitask Principal–Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design*, 7 J.L. ECON. & ORG. 24 (1991)).

78. *See* Hines et al., *supra* note 3, at 1197–98, 1205–06 (arguing that difficulty of measuring nonprofit outputs can make it hard to design incentives for managers and might allow them to cut costs at expense of quality); Jill R. Horwitz, *Why We Need the Independent Sector: The Behavior,*

The privatization literature reaches similar conclusions, although not all the lessons of that debate translate to the nonprofit context.[79] Critics of privatization argue that for-profit firms will cut costs—which are measurable—at the expense of quality—which often is not.[80] Other commentators suggest that there may be some services for which the risks of corner cutting are small and the cost savings large, so that privatization is a safer bet.[81] Perhaps, then, the IRS should authorize for-profit charity in those fields where low quality would result in little social harm. Theater, opera, and art all come to mind as potential examples.

The problem with this proposal is that it runs contrary to the basic premise of subsidies for charity. In order to determine which public goods would gain a net benefit from for-profit production, the government would first have to weigh the relative harms of low quality for each charity. That, in turn, would require explicit government judgments about the value of a charity's output. Yet that is precisely what the law of charity, as currently constructed, is designed to prevent.[82] Charitable law eliminates case-by-case evaluations of a charity's worth for fear that controversial, unpopular, or

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Law, and Ethics of Not-for-Profit Hospitals, 50 UCLA L. REV. 1345, 1410 (2003) (arguing that low-powered incentives are key to ensuring that nonprofits deliver high-quality services); *cf.* Jonathan R. Macey, *Transaction Costs and the Normative Elements of the Public Choice Model: An Application to Constitutional Theory*, 74 VA. L. REV. 417, 491–93 (1988) (claiming that public officials cannot be controlled adequately by standard incentive-based pay because there exist no useful measures on which to base the incentives). This point is also consistent with the familiar claim in the incentives literature that the usefulness of incentives as a monitoring tool declines with the ease of measuring performance accurately. Baker, *supra* note 74, at 609–11.

79. "Privatization" refers to the shift of government activities to the private—usually the private for-profit—sector. MINOW, *supra* note 3, at 1–3.

80. *See, e.g.*, *id.* at 64–65 (asserting that schooling systems governed by a privatized, incentive-based model do not take into account the fact that education is not about academic achievement alone but also involves the transmission of civic ideals to students so that they can become "productive workers and responsible citizens," and thus education "has crucial features that depart from privately consumed goods and services"); John D. Donahue, *The Transformation of Government Work: Causes, Consequences, and Distortions*, *in* GOVERNMENT BY CONTRACT: OUTSOURCING AND AMERICAN DEMOCRACY 41, 43–45 (Jody Freeman & Martha L. Minow eds., 2009) (claiming that shifting production of services to for-profit firms leads to cost-cutting as "the prime directive"); Oliver D. Hart et al., *The Proper Scope of Government: Theory and an Application to Prisons*, 112 Q.J. ECON. 1127, 1136–41 (1997) (arguing that private ownership leads to a strong incentive to strive for cost reduction and a weak incentive to engage in quality improvement).

81. *E.g.*, Karen N. Eggleston & Richard J. Zeckhauser, *Government Contracting for Health Care*, *in* MARKET-BASED GOVERNANCE, *supra* note 23, at 29, 42–43, 55–56; Hart et al., *supra* note 80, at 1141–43, 1154–55.

82. *See* JOEL L. FLEISHMAN, THE FOUNDATION: A GREAT AMERICAN SECRET 22–24 (2007) (warning that tax exemptions for donations must be available to a broad array of organizations, or else unpopular entities would not receive support); Boris Bittker & George Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299, 342 (1976) (explaining that tax-exempt organizations "enjoy the privilege of spending 'government money'" to further their independent objectives while being protected from legislative pressure regarding this spending).

novel endeavors would be judged harshly by the powers that be.[83] Thus, absent new forms of governmental decision making that might mitigate the problem of discretion, transferring some charitable functions to for-profit firms would threaten to curtail the pluralism and experimentalism of the philanthropic sector.[84]

2. *Externalities.*—As the financial-crisis example suggests, another problem with high-powered incentives is externalities.[85] Many charitable services are controversial or redistributive.[86] In both of these cases, the firm's production affects outsiders in ways that may reduce the outsiders' welfare. For example, redistributive services can reduce overall social welfare by crowding out other productive activity; recipients may consume the service rather than engage in some other transaction, such as working, that would increase welfare for the counterparty or others.[87] Since any of these effects are largely externalities for the firm and its stakeholders, allowing the firm to use high-powered incentives would increase the risk that the firm would produce too much redistribution relative to the socially optimal point.

Even if the firm does not intend to incentivize its employees to produce externalities, it may do so by accident. That seems to be the financial-crisis story: firms were each individually indifferent to the risk that their high-powered incentives encouraged their executives to take on too much systemic risk because the dangers of that systemic risk were largely externalities for the firm's stakeholders.[88] Again, to the extent that producing public

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83. *See* Atkinson, *supra* note 16, at 636–37 (warning that one of the risks of basing the tax exemption of charities on altruism theory is that "only certain favored purposes [will] be allowed to thrive"); Dean Pappas, Note, *The Independent Sector and the Tax Law: Defining Charity in an Ideal Democracy*, 64 S. CAL. L. REV. 461, 476 (1991) (acknowledging that the IRS's use of a single, broad criterion of "charitable"—that an organization "serve the public and not significantly contravene public policy"—may produce a conformist view of "charitable"); *see also* NORMAN I. SILBER, A CORPORATE FORM OF FREEDOM: THE EMERGENCE OF THE NONPROFIT SECTOR 5–6, 31–66 (2001) (tracing the history of the judicial evaluation of charity in an effort to show that judicial decisions reflect the judiciary's policy preferences).

84. It is worth emphasizing that I believe such governance innovations are possible. *See* Galle, *supra* note 34, at 80 (suggesting that organizations "should be obliged to explain why their organization deserves a subsidy, taking into account opportunity costs, moral hazard, and other possible harms to others" and that "[t]reasury officials should be empowered to consider these arguments and reject the application of organizations that lack merit, albeit while subject to careful oversight by layers of administrative and judicial review").

85. *See* Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 198 (2008) ("[N]o individual market participant has sufficient incentive . . . to limit its risk taking in order to reduce the systemic danger to other participants and third parties.").

86. *See* Pappas, *supra* note 83, at 476 (noting the potential for charitable organizations to use the benefits of tax exemption "to contravene public policy and create injustice").

87. *See* MUSGRAVE & MUSGRAVE, *supra* note 8, at 190–91 (summarizing empirical findings that social insurance crowds out work).

88. Gordon, *supra* note 72, at 364–66; *see also* Schwarcz, *supra* note 85, at 206 (noting that firms are motivated to protect themselves, not the system as a whole).

goods is even more uncertain than producing private goods, this danger of firms ignoring misaligned incentives would be higher in the nonprofit sector.

C. Is For-Profit Charity Just Different?

Finally, even if Henderson and Malani are correct that mixed firms are on average more efficient,[89] it is not obvious that this efficiency is good for philanthropy. If charity is more efficient in mixed firms, we should expect that form to crowd out pure charities.[90] That shift in the location of charity may also give rise to substantive changes. Corporations, for example, are vulnerable to objections to their work in ways that simpler nonprofits are not. Nonprofits do not have unrelated commercial product lines that can be subjected to boycott or capital stock that can be divested.[91] Thus, we might predict that corporate philanthropy will be more tepid, less willing to offend or push the boundaries of social norms.[92] Of course, donors who prefer their charity "edgy" can still donate to traditional charities, but those with limited resources may well redirect their money to less controversial but more efficient choices. In the absence of government-enforced rules for transparency and auditing, consumers might also struggle to choose the charity that matches their preferences.[93] Thus, on net, efficient corporate philanthropy might reduce the entrepreneurial character of charity as a whole.

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As a result, maintaining the current charitable sector is likely more efficient overall than Malani and Posner's proposal. Mixing the for-profit and charitable sectors increases the costs and reduces the efficacy of charities, while introducing high-powered incentives to the production of public goods exposes all of society to the risks of those incentives. There are also a variety of other negative effects, such as diminishing the diversity of charities' size and focus, that could result from the introduction of a for-profit element into the charitable realm.

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89. Henderson & Malani, *supra* note 1, at 598–600.

90. *Cf.* Bloche, *supra* note 3, at 1096–97; Eggleston & Zeckhauser, *supra* note 81, at 45 (both noting that, under competition from for-profit hospitals, nonprofits begin to behave like for-profits).

91. *See* RICHARD POSNER, ECONOMIC ANALYSIS OF LAW 455 (7th ed. 2007) (claiming that "corporations avoid controversial charities" because of potential adverse reactions from shareholders).

92. *Cf.* Sharon Dolovich, *How Privatization Thinks: The Case of Prisons*, *in* GOVERNMENT BY CONTRACT: OUTSOURCING AND AMERICAN DEMOCRACY, *supra* note 80, at 128, 134–35 (claiming that private firms will not account for values that are incommensurable with cost savings); Rose-Ackerman, *supra* note 22, at 721 (suggesting that peaceful coexistence between for-profit investor interests and existence of the nondistribution constraint would be "fragile" because of "short-term opportunism"); Williamson, *supra* note 77, at 331–32 (arguing that private firms cannot duplicate bureaucratic performance because of tensions between profit motive and public mission).

93. *See* Archon Fung, *Making Social Markets: Dispersed Governance and Corporate Accountability*, *in* MARKET-BASED GOVERNANCE, *supra* note 23, at 145, 155 (arguing that consumers have difficulty selecting products based on social preferences because there are few resources that facilitate the play of social values in economic markets).

V. Donor Mistakes

Lastly, Malani and Posner posit that tying the deduction to the nondistribution constraint may depend on a claim that donors to nonprofits lack the capacity to choose effectively between charities.[94] Irrespective of the costs to rational donors of monitoring the uses of their money, irrational or poorly informed donors may be incapable of making correct choices no matter how low the costs.[95] Alternatively, some supposed charities might be skilled at misleading donors.[96] If so, then misguided donors may allocate the government's subsidy wastefully.[97] But, Malani and Posner say, these problems are adequately dealt with by existing state and federal laws prohibiting consumer fraud.[98] And, if not, then the government should simply remove donors from the allocation process, such as through a system of government quasi-grants in which donors select a charitable activity but not a particular organization (a proposal I will refer to as the "activity-only plan").[99] While Malani and Posner's fraud argument can be pushed aside fairly easily, their challenge to the role of donors in allocating money for public-goods production is a fundamental problem for supporters of the deduction.

First, on the fraud point, there are many ways for a charity to mislead donors short of outright fraud that would therefore be beyond the reach of current antifraud laws. Credit-card companies, to take one instance, are subject to antifraud statutes like every other industry, but it is now a widely accepted finding that consumers have a very poor understanding of the terms of their credit contracts.[100]

A better argument Malani and Posner might have made—but did not—would be that additional disclosure requirements would be superior to the nondistribution constraint. That, in fact, is a proposal offered by many critics

94. Malani & Posner, *supra* note 1, at 2050. Among those who advance this argument are John Donahue and Martha Minow. *See* JOHN DONAHUE, THE PRIVATIZATION DECISION: PUBLIC ENDS, PRIVATE MEANS 33–34 (1991) (noting the tendencies of different individuals to be informed about different topics and the overall impact this has on dividing public business between the public and private sectors); MINOW, *supra* note 3, at 34 ("It is too often empirically false to assume the existence of sufficiently informed consumers.").

95. *See* Malani & Posner, *supra* note 1, at 2050–51 (arguing that some donors are unable to correctly choose between charities and, therefore, governments must be aware of this when directing or matching subsidies and donations).

96. *Id.* at 2050.

97. *Id.* at 2051.

98. *Id.*

99. *Id.* at 2051–52.

100. *See, e.g.*, Angela Littwin, *Beyond Usury: A Study of Credit-Card Use and Preference Among Low-Income Consumers*, 86 TEXAS L. REV. 451, 499 (2006) (suggesting that consumers are unlikely to understand common credit-card contract terms); Ronald J. Mann, *"Contracting" for Credit*, 104 MICH. L. REV. 899, 911 (2006) (positing that consumers are unlikely to look at credit-card contracts and consequently do not rationally consider credit-card contract terms).

of the credit-card industry.[101] Whether improved disclosure will be sufficient in the case of truly irrational consumers is unknown.[102]

More importantly, in the context of charitable donations, regulation is necessary not only to protect consumers but also other firms. Again, the nonprofit sector competes with government for the business of providing public goods.[103] Self-dealing by managers of some nonprofits can create reputational externalities for the whole sector.[104] And disclosure and enforcement actions may actually be self-defeating if they spread the perception of self-dealing or undermine the norm of self-sacrifice among other nonprofit managers.[105] The nondistribution constraint, therefore, may be more effective than disclosure, as it enables government to undertake enforcement quietly when that is the optimal solution.

Turning next to the activity-only plan, the traditional rationales for the deduction can offer only logistical quibbles to the Malani and Posner alternative. Consistent with these rationales, the activity-only plan would foster a diverse array of public goods, with taxpayers unsatisfied by the existing level of public goods able to obtain a deduction to acquire more.[106] Defenders of traditional rationales for the deduction might argue that the activity-only plan would lead each charity to reduce its own fundraising efforts in order to free ride on the efforts of others. This reduction may be a good thing if we think fundraising is wasteful, but either way, charities could check this effect by forming trade associations.[107] Another result would be that government, apparently, would have to judge the quality or at least

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101. *See, e.g.*, Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373, 1378 (2004) (arguing that additional disclosure requirements should be implemented to protect consumers from excessive credit-card interest rates).

102. *Cf.* Oren Bar-Gill et al., Product Use Information and the Limits of Voluntary Disclosure 3–4 (2009) (unpublished manuscript, on file with Texas Law Review) (arguing that some forms of mandatory disclosure may not be useful to consumers because consumers themselves have "imperfect information about how they will use a product").

103. Henderson & Malani, *supra* note 1, at 575.

104. *See* Deborah A. DeMott, *Self-Dealing Transactions in Nonprofit Corporations*, 59 BROOK. L. REV. 131, 134, 146–47 (1993) (highlighting the different standards imposed on nonprofit self-dealing and explaining why such externalities likely exist); Fishman, *supra* note 3, at 576 (noting that self-dealing and other civil and criminal wrongdoings by charitable fiduciaries have led to regulatory, legislative, public, and media scrutiny of the nonprofit sector).

105. *Cf.* Dan M. Kahan, *Trust, Collective Action, and Law*, 81 B.U. L. Rev. 333, 334–35 (2001) (arguing that conspicuous rewards and punishments can create the perception that the regulated individuals are not inclined to comply voluntarily). This point is controversial. *See, e.g.*, Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L.J. 1453, 1484–99 (2003) (arguing that the evidence is inconsistent with Kahan's hypothesis).

106. Malani & Posner, *supra* note 1, at 2051.

107. *See* MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS 145 (1971) (noting that trade associations are one tool for overcoming the political free-rider problem). Trade associations are the groups that produced, for example, the "Got Milk?" and "Pork: The Other White Meat" campaigns. Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: A Response to Market Manipulation*, 6 ROGER WILLIAMS U. L. REV. 259, 363 (2000).

expenditures efficiency of charities, leading to some increased government oversight with the accompanying danger of bias.[108]

In contrast, the Malani and Posner idea is flatly inconsistent with goals of the deduction as I have elsewhere outlined them.[109] The core of my new rationale is the competition between charities and government entities on quality.[110] It is hard to see how the activity-only plan could allow society to direct funds only to charities that outperform a specific governmental entity and to shift money away from charities that underperform government or other charities. Competition may also depend for its efficacy on warm glow feelings that accompany personal connections between the donor's actions and the resulting public good; the activity-only plan inserts a government bureaucrat between the donor and the result, which by most accounts of the warm glow phenomenon reduces its potency.

VI. Conclusion

Overall, extending the charitable-contribution deduction to include contributions to for-profit firms creates risks that are not worth the putative benefits. For-profit charity threatens to shift costs to charities, weaken the warm glow of giving, distort managerial incentives, and diminish or confuse donor choice.

This is not to say that for-profit firms have no role in the production of public goods. Firms can always contribute resources to other charities; I take no view here on whether using the firm's resources in that way would be consistent with a manager's fiduciary duty to shareholders. And government can always contract with for-profit firms to carry out select governmental functions. Oversight, accountability, and public perception all distinguish contracting from § 170 eligibility.[111] No one will likely confuse Blackwater with the United Way, either in their personnel, their fundamental goals, or in the ways in which they are responsive to their stakeholders. And it is just these factors, I have argued, that make for-profit charity problematic. Whether contracting public goods out to for-profit firms is ever attractive is a larger debate I leave for a different day.

108. *See* Atkinson, *supra* note 16, at 636–37 (cautioning that government oversight may restrict charity only to "favored purposes").

109. *See* Galle, *supra* note 34, at 52–78 (outlining the six goals).

110. *Id.* at 77.

111. *See* HOPKINS, *supra* note 14, §§ 20.1–27.17 (outlining limits on nonprofit activities and tools for government oversight of them).