Book Review

Who Benefits from the Nonprofit Sector? Reforming Law and Public Policy Towards Nonprofit Organizations

Who Benefits from the Nonprofit Sector? Edited by Charles T. Clotfelter.*
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Charity commonly is defined as “generous actions or donations to aid the poor,”¹ or “provision for those in need.”² Members of the public and the legal community believe that charity is the primary undertaking of nonprofit organizations,³ and this perception provides apparent justification for the

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1. RANDOM HOUSE UNABRIDGED DICTIONARY 348 (2d ed. 1993).

2. 1 NEW SHORTER OXFORD ENGLISH DICTIONARY 375 (4th ed. 1993).

3. See, e.g., Ralph N. Kramer, *Voluntary Agencies and the Personal Social Services*, in *THE NONPROFIT SECTOR* 243 (Walter W. Powell ed., 1987) (comparing guiding philosophies of voluntary, governmental, and for-profit social agencies). Kramer assigns charity to voluntary agencies, justice to governmental agencies, and profit to for-profit agencies. See also Daniel E. Tobert, Comment, *Regulating the Nonprofit Corporation*, 16 N. KY. L. REV. 325, 327 (1988) (“[T]he nonprofit sector today has become dominated by organizations and associations born of an ‘altruistic and voluntaristic mission’ [T]hese characteristics are the ‘true bases of nonprofit organization life’” (quoting Professor Howard L. Oleck)) (footnote omitted).

Scott Harshbarger, Attorney General of Massachusetts, had the following comments on the nonprofit sector:

diverse tax privileges and other advantages that nonprofit organizations enjoy.⁴ Whether these privileges and advantages are aimed at rewarding or encouraging charity by nonprofit organizations,⁵ the existence of such privileges creates the expectation that nonprofit organizations should provide some measure of charity.⁶

Although most charity is performed by nonprofits, charity is only one of the many activities of the nonprofit sector.⁷ A series of studies commissioned by Charles T. Clotfelter, collected in *Who Benefits from the Nonprofit Sector?*,⁸ demonstrates that charity is only a *marginal* pursuit of the nonprofit sector in every area in which nonprofit organizations are prominent: health, education, religion, social services, arts and culture, and foundations. The book's editor cogently summarizes the conclusions of the six studies:

First, there is great diversity within the nonprofit sector, and no overarching conclusions about the distributional impact can be made. This said, a second finding is one stated in the negative: in no subsector is there evidence that benefits are dramatically skewed away from the poor and toward the affluent. Conversely, there is also evidence that relatively few nonprofit institutions serve the poor as a primary clientele. A third general conclusion is that an institution's

We rely upon charities to provide services to the vulnerable—the sick, the poor, the elderly, the hungry, the homeless, and the list goes on and on—particularly when some forces in government abdicate their fundamental responsibilities to these constituencies. Also, our culture relies upon charities to enrich our lives with music and theater, and to provide wholesome activities for our children. None of us would want to imagine what life would be like in our country without charity.

Scott Harshbarger, Nonprofit Boards: Are You Doing the Right Thing?, Address Before the Educational Conference for Members of Non-Profit Boards and Management Staff (Jan. 20, 1994), in ATTORNEY GENERAL'S PACKET OF INFORMATION FOR BOARD MEMBERS OF CHARITABLE ORGANIZATIONS 7 (Commonwealth of Mass., 1994).

4. See Bazil Facchina et al., *Privileges and Exemptions Enjoyed by Nonprofit Organizations*, 28 U.S.F. L. REV. 85 (1993).

5. As Professor John Simon has written:

Those who seek an explicit link between the legal criteria for tax-blessed charitable activity and assistance to the poor will only occasionally be able to find it. Even assuming that redistribution is a *sine qua non* of the tax law, the ways of effecting it in an economy as complicated as ours cannot be spelled out with sufficient precision to become a legal standard.

John G. Simon, *The Tax Treatment of Nonprofit Organizations: A Review of Federal and State Policies*, in THE NONPROFIT SECTOR, *supra* note 3, at 84.

6. The basis for the federal exemption and many state and local tax subsidies is much broader than charity. Organizations that serve religious, charitable, public safety, literary, or educational purposes, or that operate for the prevention of cruelty to children or animals, may qualify for the exemption if they comply with the requirements of section 501(c)(3) of the Internal Revenue Code. I.R.C. § 501(c)(3) (1994). Such bodies are commonly referred to as charitable nonprofit organizations.

7. For-profit firms that seek to do charity generally use nonprofit organizations rather than for-profit firms as conduits for their charitable giving. The government's actions on behalf of the poor are largely equivalent to charitable work performed by nonprofit organizations, but are termed entitlements—something individuals receive solely on the basis of membership in society. In the United States, even government entitlements often are disbursed by social services nonprofit organizations, some of which are funded by various government agencies and others of which are funded by government contracts or grants.

8. WHO BENEFITS FROM THE NONPROFIT SECTOR? (Charles T. Clotfelter ed., 1992) [hereinafter WHO BENEFITS?].

source of funding appears to be important in determining the distribution of its benefits. Institutions which receive funding that is tied to certain objectives or recipients will tend to make expenditures reflecting those requirements.⁹

In short, the organizations that constitute the charitable sector (as defined by section 501(c)(3) of the Internal Revenue Code) are not primarily charitable.¹⁰

The publication of *Who Benefits?* coincided with a spate of media reports asserting that nonprofit organizations frequently engage in activities unrelated to their presumed charitable missions, and that executives of nonprofits plunder their organizations' resources.¹¹ The reports have engendered recent efforts by nonprofit sector insiders, legislators, and state attorneys general to force a greater measure of charitability upon nonprofit organizations, to make them more accountable, or even to strip them of some of their privileges and exemptions.¹² Unfortunately, much of the policy debate is informed more by unjustified assumptions, assertions, and expectations than by empirical evidence and a theoretical understanding of what distinguishes the nonprofit sector from the for-profit and government sectors.

9. Charles T. Clotfelter, *The Distributional Consequences of Nonprofit Activities*, in *WHO BENEFITS?*, *supra* note 8, at 1, 22.

10. How the perception of the nonprofit sector as being charitable emerged remains curious. The fact that charity is carried out almost exclusively by nonprofit organizations has certainly helped to create this perception. The image projected by the nonprofit sector's advocates and the common use of the term "charitable organizations" in reference to nonprofit organizations also have contributed to the persistence of this perception. Additionally, the difficulty of identifying charity in practice implies that only careful analysis, such as that presented in *WHO BENEFITS?*, can distinguish it from other acts and motives. This probably helps to create an impression of charity even where there is none. Thus, whereas a transfer of money from the well-to-do to the poor is probably an undisputed instance of charity, as is below-cost provision to the indigent, in many other cases noncharitable acts may be taken for charitable ones. For example, prices and fees that rise with income may be either a mark of charity (as firms ask higher-income customers to subsidize lower-income customers), or a sign of profit maximization (in which prices are based on customers' differential willingness to pay). Student discounts on airlines, in theaters, and in bookstores, for example, may therefore be both profitable and charitable. Serving poor clients may be a charitable act (e.g., if a firm forgoes some profit by not serving a wealthier clientele), but it may reflect a profitable business practice nonetheless. Examples abound of practices that have been presented as charitable but may reasonably be interpreted as aimed at profit making. See, e.g., Jeb Blount, *The Americas Profit's Not a Dirty Word at Bolivia's Bank for the Poor*, *WALL ST. J.*, Apr. 10, 1992, at A17 (describing use of such practices in banking industry); Stan Turner, *Lender Altruism, Fear of Law Helping Poor Get Mortgages*, *HOUS. CHRON.*, Mar. 2, 1994, at B1 (same).

11. Many recent stories are summarized in SALLY COVINGTON, *THE NEW AGE OF NONPROFIT ACCOUNTABILITY* (Nat'l Comm. for Responsive Philanthropy, 1994). These include, for example, the stories concerning United Way of America executive compensation and self-dealing, the lawsuit against three organizations for paying millions of dollars in charitable contributions to professional fund raisers, see Marc Lacey & Bill Billiter, *Lawsuit Alleges Fraud by 3 High-Profile Charities*, *L.A. TIMES*, Nov. 20, 1992, at A1, the high administrative expenses borne by the Freedom Forum, see Paul Farhi, *Neuharth Foundation Spares No Expense: Freedom Forum Spends Lavishly and Pays High Trustee Fees*, *WASH. POST*, Mar. 23, 1993, at A1, and the diversion of charitable contributions to support activities other than those services for which the money had been raised, see Kristin Davis, *Where Your Money Really Goes*, *KIPLINGER'S PERS. FIN. MAG.*, Dec. 1993, at 104; Liz Spayd, *Toys for Tots Spent Millions on Itself*, *WASH. POST*, Feb. 10, 1994, at A1. Such abuses within the nonprofit sector are numerous enough to fill a book—and do. See GILBERT M. GAUL & NEIL A. BOROWSKI, *FREE RIDE: THE TAX-EXEMPT ECONOMY* (1994).

12. See, e.g., COVINGTON, *supra* note 11; Pamela Sebastian, *Nonprofit Groups Seek Ethics Standard*, *WALL ST. J.*, Oct. 30, 1992, at A7.

There is no question that reform of the nonprofit sector is in order; as the studies in *Who Benefits?* demonstrate, the gap between our perception and the reality of nonprofit organizations is widening. Some nonprofit organizations fulfill primarily charitable functions—they distribute to the poor, in various forms, most of the contributions they receive. Most nonprofit organizations, however, are involved in activities that are not specifically directed at the poor or needy. Although nonprofit hospitals, universities, museums, orchestras, theaters, libraries, and other organizations may serve poor clients, at times charitably, few of these organizations can credibly claim that serving the poor is among their central goals, or that they serve other groups primarily to raise funds to subsidize goods or services for low-income customers.

What is to be done? This Review looks to the forces that lead to the creation of nonprofit organizations for answers. Nonprofit organizations, whether or not they are true charities, come into existence when for-profit firms and the government fail to meet the demands of certain groups in a particular market. Examples of demands that may go unmet include the demand of donors to support the poor, the demand of some parents for quality day care for their children, or the demand of some theatergoers to view certain plays. A for-profit firm may not meet the demand of a particular market when consumers, sponsors, or donors lack adequate information to monitor and evaluate a for-profit firm's services and use of resources. The government, in turn, fails when it cannot correct the failures of for-profit firms—often because of the particular way that the government makes political decisions regarding its activities.

When consumers, sponsors, and donors experience unsatisfactory services, they seek to alleviate the problem. For example, they may seek additional information about the operation of a day care center, use a suggestion box at the theater to identify plays that they would find interesting, or lobby the local government for changes in nursing home care. Those who remain dissatisfied may benefit from an alternative that deals with the root of their difficulties—that is, a remedy that addresses the problems of information associated with providing such services under a profit-driven form of organization. Nonprofit organizations offer such a remedy when they pursue the objectives of consumers, sponsors, and donors and do not take advantage of information they possess to turn a profit. Those who may benefit in this sense from the operations of a nonprofit organization may be said to have an economic demand for the nonprofit form. Demand for the nonprofit type of organization, therefore, originates with those who pay for the provision of a service but are dissatisfied with for-profit or governmental methods of provision.¹³

13. Beneficiaries sponsored by others may, of course, enjoy the services of nonprofit organizations without themselves having an economic demand for the nonprofit model of organization.

This Review argues that those who have an economic demand for the nonprofit form are in the best position to ensure that a nonprofit organization actually does improve upon a for-profit firm's provision of services. The shortcoming of nonprofit firms, identified in *Who Benefits?* and elsewhere, can therefore best be addressed by a legal and policy framework that enables those with a demand for a nonprofit organization to control the organization's management. Such control is necessary to ensure that nonprofits efficiently pursue the objectives of consumers, sponsors, and donors. Nevertheless, the ability of most members of this group to exercise effective control over management is limited for the same reasons that small shareholders can exert little control over large for-profit firms.¹⁴ Rectifying this situation, this Review suggests, requires improving access to the decision-making process of nonprofit organizations by consumers, sponsors, and donors and allowing them to assert more oversight of management. Such reforms should enhance support for nonprofit organizations: More donors will feel confident that their contributions are being used properly, more theatergoers will attend the productions they wish to see in nonprofit theaters, and more parents will choose to send their children to day care centers that cater to their preferences.

Part I of this Review examines evidence of the distributional effects of nonprofit activities presented in *Who Benefits?*. Part II first explores the advantages and disadvantages of policies aimed at enhancing redistribution by the nonprofit sector. After arguing that such enhanced redistribution is neither feasible nor desirable, I present a theory of nonprofit organizations focusing on market and government failures that create dissatisfaction among consumers, sponsors, and donors. Finally, I discuss the difficulties of exercising control over nonprofit organizations.

I propose several policies that would alleviate this control failure and thereby enhance the effective operation and governance of nonprofit organizations. I propose to accord legal "member" status to those consumers, sponsors, and donors who can be identified as having an economic demand for specifically *nonprofit* provision and to strengthen the fiduciary role of state government vis-à-vis nonprofit organizations on behalf of these groups. Members' rights should include improved access to information about organizations, a power to vote (with a weight proportional to contributions) for the board of directors and on matters of great importance, and legal standing in court to challenge mismanagement. State governments should help nonprofit organizations involve their members in governing; mediate disputes between members, management, and directors; and act (in extreme cases) as agents for inactive members. These measures would ensure that nonprofit organizations

14. Recent media reports suggest that management, promanagement boards of directors, or suppliers of inputs such as fundraising services may at times capture control over nonprofit organizations. See *supra* note 11. In these cases, a high proportion of donations may be diverted from the poor and needy to for-profit fundraising firms.

are governed by those who actually support them—or who would support them if they were allowed access to decision making—and would limit the ability of management to operate without accountability.

In addition, such policies would eliminate the need for many of the tax and other special benefits nonprofit organizations now enjoy. Nonprofit management opposed to increased accountability should be allowed to incorporate as some variant of a for-profit firm. "Nonprofit" status then would mean, in addition to the vague and seldom-enforceable noninurement restriction it currently represents, that an organization has real accountability to those who have a specific demand for nonprofit provision of services. Concern for the provision of services to the poor and other groups can be more effectively addressed by policies that focus directly on these services than by current broadbrush policies that regulate the nonprofit sector as a whole.

I. WHO BENEFITS FROM THE NONPROFIT SECTOR?

With the nonprofit sector producing nearly one-tenth of the gross domestic product (GDP) and playing a dominant role in the health, social services, education, and high-culture industries,¹⁵ and with major reforms underway in several of these industries, crafting a policy directed specifically towards the nonprofit sector has potentially widespread economic and social significance. Yet current policymakers are generally unable to answer the following important questions about nonprofit organizations: (1) Who benefits from their operation? (2) How efficient are they in comparison with other types of organizations? (3) Why do they exist in a market economy alongside for-profit firms and government organizations? The effectiveness of policy measures such as exemptions and separate bodies of organizational law depends on an understanding of these issues.

The identity of the beneficiaries of the nonprofit sector seems to matter much to policymakers. The seemingly widespread perception that the nonprofit sector carries out voluntary transfers of income from the better-off segment of society to the poor is reflected in current policies towards nonprofit organizations such as the granting of various tax and other subsidies. Policy reformers since the early 1980's have relied on this perception as a point of

15. It is impossible to ascertain the exact size of the nonprofit sector in terms of its contribution to the GDP. National income accounting does not identify the nonprofit sector separately from the for-profit sector, and the value of volunteers' time is not included and cannot be measured with reasonable accuracy. A useful source of quantitative information about the nonprofit sector is contained in the annual report of the Independent Sector. See INDEPENDENT SECTOR, DIMENSIONS OF THE INDEPENDENT SECTOR (1993). For a thorough attempt to quantify various aspects of the nonprofit sector, see BURTON A. WEISBROD, THE NONPROFIT ECONOMY (1988). For a detailed investigation of the nonprofit sector in comparison with the for-profit and government sectors in different industries in New York State, see Avner Ben-Ner & Theresa Van Hoomissen, *A Portrait of the Nonprofit Sector in the Mixed Economy: New York, 1981-1987*, in THE NONPROFIT SECTOR IN THE MIXED ECONOMY 243 (Avner Ben-Ner & Benedetto Gui eds., 1993).

reference. The distributional consequences of the activities of nonprofit organizations also bear on what these organizations are about, adding to this issue's policy significance.

Who Benefits from the Nonprofit Sector? represents a pioneering effort to explore a difficult area.¹⁶ It marks significant progress toward empirical resolution of the distributional issue and has implications for the broader theoretical question of why the nonprofit sector exists. Under the guidance of Charles T. Clotfelter, several scholars conducted studies of the distributional effects of nonprofit organizations. The policy-relevant objective of this collective effort was to assess the distributional effects of a small change in the size of the nonprofit sector—that is, to investigate who would benefit and who would be hurt from changes in taxes and other policy variables that would affect the size of the nonprofit sector. The book contains the detailed results of these studies.

Following the agenda-setting and overview chapter by Clotfelter,¹⁷ there are six chapters, each focusing on a particular industry. David S. Salkever and Richard G. Frank study the provision of health services by the government, for-profit firms, and nonprofit organizations, concentrating on community hospitals, mental health clinics, drug and alcohol abuse treatment facilities, and nursing homes;¹⁸ Saul Schwartz and Sandy Baum examine the characteristics of students attending nonprofit and public schools and higher-education institutions;¹⁹ Jeff E. Biddle investigates the activities of religious congregations;²⁰ Lester M. Salamon analyzes the activities of nonprofit organizations in social services;²¹ Dick Netzer focuses on organizations in the arts and culture;²² and Robert A. Margo considers the patterns of foundations' disbursement of funds.²³ The last chapter of the book includes broad-ranging commentaries by Henry J. Aaron,²⁴ Estelle James,²⁵ and Frank Levy.²⁶

The studies in *Who Benefits from the Nonprofit Sector?* survey much of the research on the distributional effects of the nonprofit sector, and also

16. As Professor Simon notes:

Indeed, it is at least difficult and perhaps impossible to determine the redistributional impact of many or most forms of charitable endeavor. The one author who has tried, in a prefatory manner, to trace the degree to which charity results in a downward shift of income and wealth, concluded that "the redistributional effects of philanthropy are incalculable in the most literal sense of the word."

Simon, *supra* note 5, at 84 (quoting Dirk Schenkkan, *Philanthropy and the Distribution of Wealth—A Preliminary Foray* (1974) (paper prepared for Yale Law School seminar)).

17. Clotfelter, *supra* note 9, at 1.

18. David S. Salkever & Richard G. Frank, *Health Services*, in *WHO BENEFITS?*, *supra* note 8, at 24.

19. Saul Schwartz & Sandy Baum, *Education*, in *WHO BENEFITS?*, *supra* note 8, at 55.

20. Jeff E. Biddle, *Religious Organizations*, in *WHO BENEFITS?*, *supra* note 8, at 92.

21. Lester M. Salamon, *Social Services*, in *WHO BENEFITS?*, *supra* note 8, at 134.

22. Dick Netzer, *Arts and Culture*, in *WHO BENEFITS?*, *supra* note 8, at 174.

23. Robert A. Margo, *Foundations*, in *WHO BENEFITS?*, *supra* note 8, at 207.

24. Henry J. Aaron, *Commentary*, in *WHO BENEFITS?*, *supra* note 8, at 237.

25. Estelle James, *Commentary*, in *WHO BENEFITS?*, *supra* note 8, at 244.

26. Frank Levy, *Commentary*, in *WHO BENEFITS?*, *supra* note 8, at 256.

examine data that some of the authors assembled specifically for this volume. The studies are competently and carefully executed; the authors have faithfully unearthed the relevant work and data sets, and their conclusions are solid. The authors focus on identifying the incidence of the benefits provided by nonprofit organizations among different income groups, explicitly ignoring other issues such as the costs of providing services, the source of funds, and the incidence of secondary benefits such as employment in nonprofit organizations and the production of public goods. The available data considerably restrict the scope of the investigations contained in *Who Benefits?*; because data problems vary across industries, the goal of producing similarly structured studies that would allow close comparisons is only partially attained. Finally, the narrowed scope of the studies does not allow much comparison of the distributional effects of the nonprofit sector with that of the government and for-profit sectors. Thus, most of the studies described below focus fairly narrowly on evaluating the “charitability” of nonprofit organizations in the common and dictionary senses.

A. *Health Services*

Information about the incomes of patients of nonprofit, for-profit, and governmental health organizations seems to be unavailable. To provide some notion of the extent to which nonprofit health facilities subsidize poor patients, Salkever and Frank²⁷ focus on patients who are funded by Medicaid and who are without insurance—most likely poor individuals. Salkever and Frank find that as a general matter:

[N]onprofit hospitals serve slightly larger fractions of the uninsured and Medicaid patients than do for-profit hospitals, but contrary findings are not lacking. There is also evidence that nonprofit teaching hospitals devote a larger fraction of their resources to serving the uninsured and Medicaid recipients than nonprofit and for-profit nonteaching hospitals. Among nonteaching hospitals, the differences between nonprofit and for-profit institutions are very small. Public hospitals on average provide a disproportionately large share of service to the uninsured and to Medicaid recipients.²⁸

Treating hospitals subsidize patients funded by public programs by charging above-cost fees to other patients and by drawing on other revenues (such as research funds and donations); such cross-subsidization, however, does not appear to occur in nursing homes.²⁹ Nonetheless, nonprofit nursing homes do not appear to be more willing than for-profit homes to serve the

27. Salkever & Frank, *supra* note 18.

28. *Id.* at 38–39.

29. *Id.* at 40.

poor; in addition, private charitable programs account for only about one-half of one percent of revenues.³⁰

A mixed and somewhat puzzling picture emerges in the case of mental health organizations. The proportion of poor in the inpatient category in for-profit facilities is only 6.7%, as compared with 38.6% in nonprofit facilities and 62.8% in public facilities. The picture, however, is drastically different for the outpatient category, where the proportion of poor is 76.5% in for-profit facilities, 56.0% in nonprofit facilities, and 74.0% in public facilities.³¹ The authors conclude: "The two findings [regarding inpatient and outpatient care] taken together suggest that for-profit programs provide relatively shorter and less expensive treatment for Medicaid recipients; another possibility is that these patients are referred to other programs when the limits on their covered Medicaid are reached."³²

The findings concerning health services are not free of problems.³³ But the basic result is clear: Nonprofit health services institutions are slightly more inclined to subsidize care for the poor and to treat more poor than for-profit institutions, but (1) they do so less than public institutions, and (2) they are not primarily or even moderately in the charity business.³⁴

B. Education

The public secondary school system redistributes income to the poor from the rest of society merely because it is free and open to all. Private nonprofit

30. *See id.*

31. *See id.* at 45 tbl. 2.10.

32. *Id.* at 45–46. There is very little information about the income characteristics of patients of the diverse facilities that provide treatment for alcoholism and drug addiction. Source of funding is a very weak indicator of the incomes of patients in a given facility because revenues, whether from private or public sources, typically cover the costs of treatment. Nonprofit facilities receive very little revenue from donations (which account for 2.5% of total revenues in alcoholism services and 3.1% in drug abuse services), whereas for-profit facilities enjoy almost none (0.1% and 0.2%, respectively, of total revenues), but there is no evidence that these funds go toward subsidization of treatment for the poor. Another bit of evidence suggests that "on the whole, patients served by for-profit providers have higher incomes, patients served by public providers have the lowest incomes, and patients served by nonprofit providers (some of whom are beneficiaries [that is, receive subsidized care]) presumably have income levels between these other two groups." *Id.* at 50.

33. For example, the allocation of patients to facilities is not entirely random, both because founders select a location that has a certain type of population, and because patients choose, at least in some cases, in what type of facility to enroll. Salkever and Frank recognize this issue of selectivity bias. *See id.* at 39; *see also* Aaron, *supra* note 24, at 237–40; Alphonse G. Holtmann & Steven G. Ullmann, *Transaction Costs, Uncertainty, and Not-For-Profit Organizations: The Case of Nursing Homes*, in *THE NONPROFIT SECTOR IN THE MIXED ECONOMY*, *supra* note 15, at 149, 158–59.

34. In an analysis of the interaction among the three sectors in the hospital industry, the authors find that the presence of public hospitals reduces nonprofit hospitals' propensity to care for the poor (perhaps because public hospitals attract the indigent away from nonprofits); a similar result holds for the relationship between for-profit and nonprofit hospitals. Salkever and Frank conclude that "it appears that growth in the nonprofit share of the hospital market at the expense of public hospitals would probably result in a net reduction of the aggregate supply of hospital care for the indigent," but if "nonprofit hospital growth came at the expense of for-profit providers, the result would be a net increase in indigent hospital care." Salkever & Frank, *supra* note 18, at 53–54.

secondary schools are not free. Although they seem to charge lower fees to students from poor families, the extent of subsidy is not known. Private nonprofit schools also are not open to all children who wish to enroll. Therefore, nonprofit secondary schools do less to redistribute income to the poor than public schools.

This conclusion would be wrong if, broadly speaking, public schools offered little educational value to poor students in comparison with private schools or if private schools offered considerable subsidy and access to poor students. Unfortunately, the comparative data on public and Catholic schools presented by Schwartz and Baum³⁵ do not address these issues. The authors present data on the distribution of students in public and private schools, but not on the extent of subsidization,³⁶ and they focus on the effects of private versus public secondary education on levels of achievement of students from families with different incomes.

Various measures indicate higher academic performance in Catholic schools than in public schools (elite private schools are not included in the comparison) for students from all income backgrounds. Selectivity bias, however, undermines the value of these findings because the outcomes of education are not independent of the choices of both schools and parents: Catholic schools select the students they admit, and parents who send their children to Catholic schools could have sent them to public schools but chose to do otherwise. The factors that underlie these choices (e.g., commitment to education and religion, parents' income, etc.) may also affect educational experiences and scholastic achievements. These issues are not fully addressed by Schwartz and Baum's analysis because of insufficient data.³⁷

While these authors cannot say much about the relative distributional impact of private nonprofit and public secondary schools,³⁸ they do compare redistributive effects of private and public colleges and universities. They analyze enrollment in private and public institutions by levels of student family

35. See Schwartz & Baum, *supra* note 19.

36. Survey data cited by the authors suggest that in 1980, 8% of students in public secondary schools came from families with an annual income of less than \$7000, versus 2% in Catholic schools and 1% in elite private schools. Students from families with annual incomes of \$7000 to \$11,999 made up 13% of public school enrollment, versus 7% in Catholic schools and 1% in elite private schools. Students from families with annual incomes of \$25,000 to \$37,999 represented 13% of total public school enrollment, 18% of Catholic school enrollment, and 13% of elite private school enrollment. Students from families with annual incomes of \$38,000 or above represented 10% of total public school enrollment, 19% of Catholic school enrollment, and 69% of private elite school enrollment. *Id.* at 56.

37. In his commentary, Frank Levy concludes: "Unless Schwartz and Baum can come up with evidence, even in one metropolitan area, as to who pays what, the distribution of benefits will remain a mystery." Levy, *supra* note 26, at 259. The Coleman study of differences between public and private schools, JAMES S. COLEMAN ET AL., *HIGH SCHOOL ACHIEVEMENT: PUBLIC, CATHOLIC AND PRIVATE SCHOOLS COMPARED* (1982), was criticized along similar lines. See, e.g., Richard J. Murnane, *A Review Essay—Comparison of Public and Private School: Lessons from the Uproar*, 19 J. HUM. RESOURCES 263, 265–66 (1984).

38. Schwartz and Baum use the terms "private" and "nonprofit" interchangeably in describing private nonprofit schools.

income, distribution of subsidies by family income, and the returns students receive from their education.³⁹ The likelihood of a student attending a public college or university declines as his or her family's income increases.⁴⁰ Students of both public and private nonprofit institutions may receive aid from a public or private entity to assist in paying tuition and fees; this is direct, or need-based, subsidy. Students also may receive indirect subsidy when tax supports or private contributions cover any difference between the cost of education and the total receipts from tuition (including the portion subsidized by any public or private entities).⁴¹ Data on direct subsidies are available, but information on indirect subsidies depends upon numerous assumptions concerning the portion of expenses that are allocated to education versus research, service, and outreach, and concerning the portion of educational expenses allocated to particular programs of study.⁴²

Among those who enroll in higher-education institutions, the poor and near poor who study in the public sector receive a greater proportion of direct subsidies than their counterparts in the private nonprofit sector. Because the cost of attendance at private institutions is considerably higher than in public ones, however, the direct subsidies granted in the nonprofit sector are two to seven times higher (depending on the income group) than in the public sector. In both sectors direct subsidies are progressive, declining with family income.⁴³

Indirect subsidies alter the picture considerably because they are generally regressive, and more so in the public than in the nonprofit sector.⁴⁴ Indirect subsidies per student are much larger than direct subsidies, and indirect subsidies are twice as high in the public sector as in the nonprofit sector.⁴⁵ The result is that total (direct plus indirect) per-student subsidies are greater across all income groups in the public sector than in the nonprofit sector.

39. Schwartz & Baum, *supra* note 19, at 70–86.

40. For example, in 1985, about 75% of students from families with incomes of less than \$50,000 went to public institutions. This percent declines as income increases, to 70.8% for families with incomes between \$50,000 and \$75,000, 65.4% for families with incomes of \$75,000 to \$100,000, and 49.3% for families with more than \$100,000. Of the poorest students (from families with less than \$12,000 in annual income in 1985), 18.8% attended private nonprofit institutions and 8.0% attended private for-profit institutions, presumably vocational and technical schools. *Id.* at 72.

41. *Id.* at 76.

42. Reporting on the assumptions they made to measure indirect subsidies, Schwartz and Baum write that “this is a very rough approximation of the cost of educating students and alternative definitions might yield different results.” *Id.* at 79 n.20. It would have been a good idea to generate alternative measures of indirect subsidies on the basis of different assumptions, especially in view of the crucial role they play in identifying the redistribution effects of public versus nonprofit higher-education institutions.

43. *Id.* at 79.

44. *Id.* This is presumably so because there is a positive correlation between the students' family income and the type of institution they attend, controlling for sector. That is, the data imply that students from higher-income families tend to attend institutions where the cost of education is higher. It is impossible to tell whether this is true or not from the data provided by the authors (who do not explore this issue). It is conceivable that higher-income students choose to attend universities (rather than colleges) where a component of research expenses is classified as an educational expense.

45. *Id.*

Schwartz and Baum conclude, however, that total subsidies are more progressive and pro-poor in the nonprofit sector than in the public sector.⁴⁶

Here, the authors consider only the distributional effects upon those who enroll in institutions of higher education. They note:

When the focus shifts from average subsidies *per student* to average subsidies *per young person*, the distribution of average subsidies becomes markedly pro-rich instead of mildly pro-poor. This is a result of a system in which young people from upper-income families are considerably more likely to go to college than young people from lower-income families.⁴⁷

Whatever the reality of subsidies might be, graduates of private colleges earn essentially the same amount after graduation as graduates of public colleges. Earning differences are explained more by college major and grades than by the nonprofit/public distinction.⁴⁸ The study's authors do not, however, attempt to draw distinctions between the diverse types of nonprofit and public institutions. For example, whether attending an Ivy League institution carries a future income premium cannot be discerned from this study.

C. Religious Congregations

Almost all religious congregations are organized as nonprofit organizations. Religious organizations enjoy a special status and privileges not conferred on other nonprofit organizations, such as being exempt from IRS income and expenditure reporting requirements. Religious congregations receive the largest share of Americans' annual donations of money and volunteer labor, most likely more than half of total contributions.⁴⁹ Jeff Biddle studies the activities of congregations of major religions and the activities to which these groups contribute funds.⁵⁰ Of the \$68 billion estimated to have flowed through

46. *Id.* at 87.

47. *Id.* Although this is an interesting and useful observation, the per-person calculation ignores possible subsidies nonstudents may receive.

48. *Id.* at 74. There are some minor exceptions, such as the approximately 5% premium earned by graduates of Eastern private colleges over their public counterparts. Schwartz and Baum rely for these findings on Estelle James et al., *College Quality and Future Earnings: Where Should You Send Your Child to College?*, 79 AM. ECON. REV. PAPERS & PROC. 247 (1989). Analysis of a different data set by Schwartz and Baum generated similar conclusions. Schwartz & Baum, *supra* note 19, at 74-75.

49. See Clotfelter, *supra* note 9, at 14-18; Christopher Jencks, *Who Gives to What?*, in THE NONPROFIT SECTOR, *supra* note 3, at 321, 322.

50. Biddle, *supra* note 20. Biddle does not consider organizations such as Catholic charities, hospitals affiliated with religious organizations, and various philanthropic bodies associated with Protestant denominations or with regional and national Jewish federations. See *id.* at 92-93 (noting that such organizations do not rely heavily on donations by religious congregations). These organizations are included, however, in the chapters on health services, social services, arts and culture, education, and foundations in *Who Benefits?*

religious congregations in 1989,⁵¹ Biddle estimates that some 70% went to the provision of services to congregation members, while "[c]lose to 30 percent of congregational expenditure . . . is philanthropic in nature, including that which addresses the specific material needs of individual members of the congregation and that which supports the provision of services to people regardless of their affiliation with the congregation."⁵² Given the physical segregation of different socioeconomic classes⁵³ and the tendency of congregations to be locally focused, it is not clear how much of this philanthropy is directed to the poor.⁵⁴

Biddle's chapter does not provide any evidence that income redistribution actually takes place within congregations, or that the tax and other benefits conferred on religious congregations enable poorer parishioners to enjoy more services. Although a much greater share of the contributions made by poor people go to religion, and although poor people donate a higher proportion of their income than wealthy people,⁵⁵ they enjoy fewer tax benefits because a much smaller percentage of lower-income groups itemize their tax returns.⁵⁶ Hence it seems reasonable to hypothesize that tax subsidies predominantly benefit higher-income groups.

D. Social Services

The strongest expectation of charitability is directed at the social services segment of the nonprofit sector. Such services include job training, income support, legal representation, and environmental protection. While government at all levels is the most important source of funding for social services activities,⁵⁷ the nonprofit sector dominates the provision of these services.⁵⁸

51. *Id.* at 124.

52. *Id.* at 125. Information about religious congregations is extremely limited because, as tax-exempt organizations, they are not required to report details of their activities to the IRS.

53. Biddle, for example, notes that "American congregations tend to be segregated on the basis of income." *Id.* at 109.

54. Whereas some congregations raise money through unconditional donations, others levy membership fees on the basis of ability to pay, akin to sliding-scale fees for health services. *Id.* at 114; see *supra* text accompanying note 29. But this does not necessarily mean that "richer parishioners clearly subsidize poorer ones," Biddle, *supra* note 20, at 114, because, as noted, this practice is compatible with control by the richer parishioners who seek to maximize revenues.

55. Clotfelter, *supra* note 9, at 16.

56. See Jencks, *supra* note 49, at 322-23.

57. Government provides the largest share of the income of nonprofit human services agencies (38%), followed by private giving (31%), fees (23%), and other sources (8%). Salamon, *supra* note 21, at 142. The data are for the early 1980's and come from Salamon's survey of nearly 2300 nonprofit organizations, sponsored by the Urban Institute. On the basis of the tax returns of nonprofits in New York State for the same period, Ben-Ner and Van Hoomissen find somewhat higher government contributions (about 40% of total revenue), lower private giving (about 21% total, 15% from individuals and 6% from federated fundraising organizations), higher shares of fees (around 28%), and other sources, such as membership dues and interest and dividends (11%). See Ben-Ner & Van Hoomissen, *supra* note 15, at 259-60 & tbl. 9.

58. In New York, the for-profit sector provides 11.0% of the industry's employment, as compared with the nonprofit sector's share of 85.5%, and the government's share of 3.3%. See Ben-Ner & Van Hoomissen,

Salamon finds that only 27% of nonprofit social services organizations in his survey reported that the poor constituted half or more of their clientele. Some 53% of the organizations claimed to serve few or no poor clients.⁵⁹ Source of funding apparently affects an organization's client orientation: The greater the share of financial support from the government and from the United Way, the stronger the organization's orientation towards the poor.⁶⁰ Salamon provides no information on the extent to which for-profit firms in social services act as conduits of public funds for the benefit of the poor. Nor does Salamon include information about the extent to which the organizations included in his survey subsidize clients or about the incomes of those who contribute money and time to the organizations. As a result, it is impossible to appraise the distributional impact of the nonprofit social services sector. Nonetheless, it is clear that social services organizations do not operate only, or even primarily, for the benefit of the poor.

E. Arts and Culture

There is a fairly clear division of labor between the for-profit and nonprofit sectors in the cultural sphere: The former produces mass culture, the latter high culture.⁶¹ Netzer attempts to distinguish between multiple classes of beneficiaries as well as between various sources of their revenues. Just about two-thirds of direct benefits of nonprofit organizations in arts and culture accrue to people in the upper half of the income distribution, and about 30% to those in the upper sixth.⁶² The revenues of these organizations stem from fees and income contributed by individuals, corporations, foundations, and the government (including income tax deductions by individuals, corporations, and foundations). After carefully analyzing the available data, Netzer concludes that "there is little or no redistribution from the upper to the lower half of the income distribution, but significant redistribution from the highest income-receivers to the one third just above the median."⁶³

supra note 15, at 248.

59. Salamon, *supra* note 21, at 149. Although 53% of "employment, training, and income support" organizations claimed to serve mostly poor clients, 37% of them had few or no poor clients. The remaining 10% had some poor clients, defined as between 20% and 50%. Among legal rights and advocacy nonprofit organizations, 43% served mostly the poor, 19% had some poor clients, and 38% had few or no poor clients, whereas in "education, research," 10% of organizations served mostly poor clients, 12% had some poor clients, and 78% had few or no poor clients. *Id.* The fields of operation are not defined clearly; for instance, it is unclear what "education, research" means.

60. *Id.* at 157-59, 169-70.

61. Netzer, *supra* note 22, at 175.

62. *Id.* at 195.

63. *Id.* at 199-200. Netzer is the only contributor to *Who Benefits?* who attempts to include employees of nonprofit organizations in the examination of the distributional effects of the nonprofit sector. *Id.* at 191-93.

A comparison of net benefits derived by consumers in the for-profit sector is lacking.⁶⁴ Nevertheless, two conclusions may be reached. For nonprofit organizations created during the nineteenth century to promote arts and culture, "the redistributive goal from the outset often was very secondary to the primary goal of establishing clubs to make possible cultural experiences that would be enjoyed, if not solely by the very rich who were the initial organizers and backers, then by the relatively educated and affluent upper-middle-class."⁶⁵ Even today,

[t]he bulk of the benefits of the activities of nonprofit arts and cultural organizations are realized by people in the upper half of the income distribution [Yet,] [t]he frequent allegation that support of the [nonprofit sector in arts and culture] from tax funds and tax-deductible gifts is a transfer from those in the middle of the income distribution to those at the top of the distribution is a caricature.⁶⁶

F. Foundations

The majority of foundations (82.6%) are independent (or private nonoperating) foundations, and most assets of foundations (85.9%) are held by independent foundations.⁶⁷ Company-sponsored and community foundations (and a small number of operating foundations that rarely make grants) account for the remainder of foundations and their assets. There are no data that can clarify the distributional effects of foundation grants. Margo examines the broad expenditure pattern of foundations and finds that in 1988, 17.1% of grants went to education, 20.2% to health, 27.0% to social welfare, 19.1% to scientific research, 14.5% to culture, and 2.0% to religion.⁶⁸ We have seen, however, that nonprofit organizations in these areas do not necessarily redistribute income, and many serve the well-to-do. Without further information about the recipients of these grants and the uses to which money is put, it is impossible to ascertain the distributional effects of foundation grants. Criticisms of foundations as institutions that preserve the extant income distribution⁶⁹ are only weakly countered by Margo's study, which concludes: "Although only a minority of foundation grant dollars can be readily classified as pro-poor, it would be premature to conclude that foundations were

64. As stated several times in this Review, the fact that higher-income individuals pay higher fees does not imply that they, or the organizations that receive these fees, seek to support lower-income individuals. Broadway productions maximize profits when tickets for the same seats are sold at different prices, such as when lower-income spectators wait in line for cheaper tickets.

65. Netzer, *supra* note 22, at 174.

66. *Id.* at 202.

67. Margo, *supra* note 23, at 211.

68. *Id.* at 221.

69. See, e.g., TERESA ODENDAHL, CHARITY BEGINS AT HOME: GENEROSITY AND SELF-INTEREST AMONG THE PHILANTHROPIC ELITE (1990).

regressive in their impact; low-income households may ultimately benefit from foundation grants for medical and scientific research, and some foundations are more pro-poor than others."⁷⁰

G. *Conclusions: Who Benefits?*

The operation of the nonprofit sector affects the distribution of income and other economic activities through its employment and compensation practices, sources of revenues, effect on taxes, and disbursement of services. Whether the nonprofit sector has a more or less egalitarian or pro-poor effect than the for-profit and government sectors is difficult to conceptualize, let alone answer. The editor of *Who Benefits?* suggests an interesting conceptual device: Evaluate who would benefit and who would be harmed by a small change in the size of the nonprofit sector.⁷¹ But this conceptual mechanism is impossible to apply, because suitable data are unavailable;⁷² for example, most studies report the distribution of different income groups among the clientele of the nonprofit sector without comparing it to the other two sectors.

Nonetheless, the book is rich in facts and empirical analysis that unmistakably point to the conclusion that nonprofit organizations do not operate primarily to serve the poor or to redistribute income toward lower-income groups. But neither is there a strong pro-rich orientation in any of the industries examined in the book. The organizations that constitute the nonprofit sector seemingly promote the welfare of those who make donations to them and partake in their activities. Most lower-income people have less contact with the nonprofit sector than higher-income people. In industries where there are alternatives to the nonprofit sector (that is, where it does not provide the bulk of services)—such as health care, education, and arts and culture—the probability of a person being served by a nonprofit organization seems related to income.

The studies do not reach any strong conclusions about the nonprofit sector's distributional effects compared with those of the government sector. It would be interesting to investigate whether a tax dollar spent in the nonprofit sector in a particular industry does more to alleviate poverty than a dollar spent in the public sector in that same industry. *Who Benefits from the Nonprofit Sector?* thus debunks the image of the nonprofit sector as charitable in the

70. Margo, *supra* note 23, at 232–33.

71. See Clotfelter, *supra* note 9, at 12.

72. See Aaron, *supra* note 24, at 240 (unavailability of data for differences between payments of various patient groups and cost of serving these groups); James, *supra* note 25, at 245 (unavailability of data for willingness to pay for nonprofits); Levy, *supra* note 26, at 259 (unavailability of data for who pays for Catholic education); see also Richard Steinberg, 31 J. ECON. LITERATURE 915, 916 (1993) (book review) (hypothesizing that distributional impacts of nonprofit sector have been neglected because of perception that data and conceptual problems would preclude meaningful progress).

sense of providing significant support for the poor, but it leaves many distributional and other questions unresolved.⁷³

II. REFORMING LAW AND PUBLIC POLICY TOWARDS THE NONPROFIT SECTOR

What objectives should drive public policy towards nonprofit organizations? Should policies encourage charitable behavior by nonprofit organizations? In Section A, I argue briefly against this position, suggesting that the poor will be served better through other means. In Section B, I develop a theory of nonprofit organizations that suggests a different criterion for guiding public policy towards nonprofits. Specifically, nonprofits are private, nongovernmental organizations that do not aim to maximize profits for distribution to their owners or controllers, but that do have some service objectives to members, users, or other beneficiaries.⁷⁴ Yet, nonprofits often are unable to achieve their objectives due to severe governance problems. As outlined, policy towards nonprofit organizations should be designed to alleviate these severe governance problems.

A. Public Policy and Income Redistribution via the Nonprofit Sector

Can government policies induce the nonprofit sector to behave more charitably?⁷⁵ Generally, greater tax and other subsidies will increase nonprofit activity (although only by a small measure)⁷⁶ and therefore will augment the scale of its charity. But unless subsidies are correlated specifically to nonprofit organizations' charitable activities, or are granted only to truly charitable nonprofit organizations, the proportional levels of charity detected in *Who*

73. See also Avner Ben-Ner & Theresa Van Hoomissen, *An Empirical Investigation of the Joint Determination of the Size of the For-Profit, Nonprofit and Government Sectors*, 63 ANNALS OF PUB. & COOPERATIVE ECON. 391 (1992). The authors examined the determinants of the size of the nonprofit sector in New York State in 1982 and 1987 in health services, primary and secondary education, social services, and day care for young children (a subset of social services). They found that the proportion of the population that is poor (defined as the percentage of the population participating in income maintenance programs) displays negative correlation with the number of employees in the nonprofit organizations in health services industries, positive correlation with nonprofit employment in social services, and no correlation with employment in other industries. Interestingly, both for-profit and, to a lesser extent, local government employment in health services are positively correlated with the proportion of poor. The higher the proportion of the population with more than 16 years of education, and hence higher incomes, the greater the nonprofit employment in primary and secondary education.

74. This definition draws on Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE LJ 835 (1980), and on Avner Ben-Ner et al., *Basic Issues in Organizations: A Comparative Perspective*, 17 J. COMP. ECON. 207 (1993).

75. Simon argues, "[I]t is not at all clear that legislative bodies, federal or state, American or British, have adopted the assumption . . . that redistribution is a sine qua non of charitable exemption and deductibility Congress has never imposed redistributional requirements." Simon, *supra* note 5, at 85.

76. For instance, Hansmann finds that although differences in tax subsidies across states affect the market share of the nonprofit sector, the effects are small. Henry Hansmann, *The Effect of Tax Exemption and Other Factors on the Market Share of Nonprofit Versus For-Profit Firms*, 60 NAT'L TAX J. 71 (1987).

Benefits? will probably not change. For example, making donations tax deductible increases donations.⁷⁷ But since this deduction currently exists for taxpayers who itemize their returns, its effects are already in place, although they could be enhanced by increasing marginal tax rates. Given the tax-price elasticity of donations of about -1.0 to -1.5, the growth in donations caused by a small increase in tax rates would be rather small,⁷⁸ and the main beneficiaries would be religious organizations.⁷⁹ Nonprofit organizations are already exempt from corporate income taxes, and, in most states, are fully exempt from property taxes; it is unlikely that these tools can be used to increase charitable behavior.

An alternative policy to enhance nonprofit organizations' charitability would require organizations to spend a certain portion of their revenue on redistributive or pro-poor activities. Elements of such a policy are already in place at the federal level and in some states.⁸⁰ If, however, the purpose of tax subsidies is to encourage the charitable activities of the nonprofit sector, this objective could be pursued much more effectively through targeted subsidies.⁸¹ Withdrawing tax benefits and other subsidies from nonprofit organizations and shifting funds to those organizations and government agencies engaged in activities aimed at income redistribution will lead to more charitable behavior than the nonprofit sector performs today.⁸²

77. Jencks, *supra* note 49, at 328-29.

78. For some examples, see *id.* at 330-31.

79. See *supra* text accompanying note 49.

80. For example, the IRS requires that some nonprofit organizations resembling for-profit firms, such as consumer credit counseling agencies, exclusively serve low-income persons in exchange for a grant of 501(c)(3) status. Nonprofit hospitals once were required to open their emergency rooms to all. Nonprofit nursing homes that provide housing and health services tailored to the needs of the aged must provide services at the lowest cost, and must not discharge residents who become unable to pay their fees. See Simon, *supra* note 5, at 85; see also THE ATTORNEY GENERAL'S COMMUNITY BENEFITS GUIDELINES FOR NONPROFIT ACUTE CARE PROGRAM (Commonwealth of Mass., Draft Jan. 24, 1994).

81. See Charles T. Clotfelter, *Tax-Induced Distortions in the Voluntary Sector*, 39 CASE W. RES. L. REV. 663 (1988-89); Jerald Schiff & Burton Weisbrod, *Competition Between For-profit and Nonprofit Organizations*, in THE NONPROFIT SECTOR IN THE MIXED ECONOMY, *supra* note 15, at 127, 139-41; see also BRADFORD GRAY, WHY NONPROFITS? HOSPITALS AND THE FUTURE OF AMERICAN HEALTH CARE (Program on Non-Profit Organizations, Yale University, Working Paper No. 171, 1991).

82. The size of the nonprofit sector would drop somewhat because of the withdrawal of benefits but would increase due to transfer of earmarked funds. The net effect may go either way, depending on detailed assumptions about the behavior of donors and nonprofit organizations, how funds are earmarked, etc.

B. *The Nonprofit Sector in the Mixed Economy*⁸³

In countries such as the United States, where the economic system is based on markets, private ownership, and the pursuit of profit, the very existence of nonprofit firms may seem perplexing—particularly where the legal system embraces the for-profit firm. It is essential, though, to understand why nonprofit organizations exist in order to comprehend what they do, and what regimes should govern their behavior.

In a perfectly competitive economy—an economy in which market participants can adequately distinguish, evaluate, and acquire goods and services—the for-profit firm is the optimal form of organization. The actual economic world, however, is complicated by the existence of market power, asymmetric information, various forms of positive and negative externalities, and public goods. In many cases unfettered market provision of goods and services by for-profit firms is infeasible or undesirable, and the “public” has a demand for an alternative type of organization. As purveyor of the “public good” and possessor of the power to tax, the government is, in principle, in a position to form and run such an organization.

For various reasons, governments do not respond to all market failures to the satisfaction of all those affected;⁸⁴ some individuals and groups will remain dissatisfied with the level, quality, and price (or tax price) of certain goods and services provided, if at all, by for-profit firms and various government units. These individuals and groups have a demand for an alternative type of organization, a form that coincides approximately with what is commonly termed the nonprofit organization. The creation and effective operation of nonprofits depend on whether at least some of these individuals and groups are willing and able to support and to participate in governing nonprofit organizations.

1. *Parties with an Interest in the Nonprofit Organization: The Nonprofit Demanders*

Consider the individuals and groups with an economic demand for a certain good or service. They are willing and able to pay for some quantity of

83. This Section draws on Avner Ben-Ner and Theresa Van Hoomissen, *Nonprofit Organizations in the Mixed Economy: A Demand and Supply Analysis*, 62 ANNALS OF PUB. & COOPERATIVE ECON. 469 (1991); see also THE ECONOMICS OF NONPROFIT INSTITUTIONS (Susan Rose-Ackerman ed., 1986); THE NONPROFIT SECTOR, *supra* note 3; THE NONPROFIT SECTOR IN THE MIXED ECONOMY, *supra* note 15. The economic literature on the nonprofit sector is reviewed in each of these volumes, and in ESTELLE JAMES & SUSAN ROSE-ACKERMAN, *THE NONPROFIT ENTERPRISE IN MARKET ECONOMIES* (1986).

84. Inevitably, the determination of the level and composition of government activities is highly politicized. See generally DENNIS MUELLER, *PUBLIC CHOICE II* (1989). One version of this problem is captured simply by the “median voter” model, which suggests that government’s activities are directed toward the demand of the median voter, leaving above-median voters with unsatisfied demands. Heterogeneity among the citizenry that votes in a particular jurisdiction exacerbates this problem.

it, for their own consumption or for the consumption of others they care about. They thus have a stake in the price, quantity, quality, and other attributes of the good or service: They are *demand-side stakeholders*. Demand-side stakeholders include consumers, customers, donors, and sponsors. Examples of demand-side stakeholders and the corresponding good or service include the following: parents as sponsors of day care for young children; local government as sponsor of psychological guidance for teens; the paying audience as customers of and supporting foundations as donors to art exhibitions; volunteers as donors of time to a soup kitchen; contributing individuals and governments as sponsors of relief actions in Rwanda. In these examples, some of the beneficiaries are demand-side stakeholders, but others—children in day care, teens in counseling programs, nonpaying audiences at the exhibition, homeless individuals at a soup kitchen, refugees in Rwanda—are not, because they do not pay for the services in question and therefore have no *economic* demand. Economic demand is the source of voluntary action in a market economy.

A number of factors affect the degree to which demand-side stakeholders are dissatisfied with the for-profit provision of goods and services. The various attributes of a particular good or service will have different salience for different individuals, depending upon taste and income. Achieving a mix of attributes that satisfies demand-side stakeholders is particularly difficult in two circumstances: when a good or service has salient “nonrival attributes,” and when a good or serves has “incompletely observed” attributes.⁸⁵

A nonrival attribute is one that may be enjoyed at no additional cost by any number of demand-side stakeholders, subject only to a capacity constraint. For example, a theater hall enables all spectators to enjoy the same show; the same level of service is provided to all consumers, subject only to limits on the number of seats. A rival attribute, on the other hand, is one whose consumption by one individual excludes its consumption by other individuals. A particular seat in a theater hall or the care given to a particular child in a day care center are examples of rival attributes. Nonrival attributes are generally more prominent in services than in goods.

In some cases, nonrival attributes are much more expensive to produce than rival attributes.⁸⁶ Such nonrival attributes can be termed collective attributes, and the goods and services that possess them can be designated as

85. The ultimate source of the problem of unsatisfied demand stems from market failures; therefore it is useful to focus on such failures in the context of demand for the nonprofit type of organization. Alternatively, one could focus on government failures, both to correct market failures and to provide services in a satisfactory manner to all demand-side stakeholders. See Burton A. Weisbrod, *Toward a Theory of the Voluntary Non-profit Sector in a Three-Sector Economy*, in ALTRUISM, MORALITY, AND ECONOMIC THEORY 171 (Edmund S. Phelps ed., 1975).

86. For a more precise discussion of these issues, see Avner Ben-Ner, *Nonprofit Organizations: Why Do They Exist in Market Economies?*, in THE ECONOMICS OF NONPROFIT INSTITUTIONS, *supra* note 83, at 94.

"collective goods." For-profit firms can satisfy demand for collective goods only if there are numerous demand-side stakeholders. If there are few demand-side stakeholders, even with relatively high demand, providers of a collective good will aim to satisfy "average" demand-side stakeholders, leaving those with high demand willing to pay more for the collective attribute.⁸⁷ Providers will charge higher prices if high-demand stakeholders reveal their demands to the provider. The provider, however, can use this information to increase profits at the expense of stakeholders. Without assurances that this will not happen, demand-side stakeholders will not reveal their demand to for-profit firms. To secure such assurances, stakeholders must gather information about the finances and operation of the firm that will serve as a basis for an enforceable contract between the firm and demand-side stakeholders. Many individual stakeholders, having too little to gain from costly writing and enforcement of such contracts, will not enter into them. Market failure thus stems from a breakdown of the flow of information through ordinary market channels.⁸⁸

"Incompletely observed" attributes pose a related problem. Demand-side stakeholders cannot verify, or can verify only at great cost, the provision of salient attributes of a good or service.⁸⁹ Goods and services with such difficult-to-verify attributes will be termed "trust goods." For-profit firms have an incentive to take advantage of demand-side stakeholders' limited information concerning trust goods by providing a service of inferior quality or by charging a higher-than-normal price. In many instances, remedies provided by market-based mechanisms—such as firm reputations, self-regulation, or government regulation—alleviate this problem entirely.⁹⁰

87. In the case of rival attributes, each consumer can be provided with exactly what he or she wants. The consumer pays a price that equals the cost of producing the unit of the rival attribute.

88. The result might be different when the demand-side stakeholders are organizations rather than individuals. For example, the federal government and some firms have the technical ability as well as the incentives to contract with for-profit firms to obtain access to information, and such groups can participate in designing the price-quantity-quality combination of the services they purchase. Nevertheless, many demand-side stakeholders, especially individuals who share in the consumption of a service with many other individuals (e.g., theatergoers), are unable to process the information necessary to specify in a contract the feasible and desirable price-quantity-quality package. The individual costs of engaging in the requisite actions (which may include the hiring of qualified agents to act on behalf of demand-side stakeholders) will often be greater than the benefits to any individual. In addition, a free-rider problem occurs when individual stakeholders misrepresent demand in order to pay low prices but enjoy the services they desire.

89. Examples include services provided to third parties on behalf of sponsors, such as day care for young children who cannot report information about levels of quality to their parents, or the services provided by aid agencies to refugees in Rwanda using donations from contributors located in distant places. Other examples include goods and services whose usefulness and other attributes cannot be ascertained until after they are purchased (e.g., canned goods, durable goods, and medical care).

90. It is interesting to note that the modern consumer cooperative movement, born in 1844 in Rochdale, England, represented a reaction to the sale of adulterated flour and other "shoddy" goods in local stores. In developed economies, this problem largely has been solved through a combination of government regulation and the concern of manufacturers and merchants for their reputations. Contemporary consumer cooperatives seem to be particularly active in protecting their members from fraudulent claims of sale of organic foods, especially in states where there is little government regulation and where the size of the market is too small to have allowed for the evolution of sufficiently large producers who can be recognized

As in the case of collective goods, the market failure here stems from insufficient distribution of information through the market. In both cases the problem cannot be resolved because demand-side stakeholders do not trust for-profit firms' motives. In particular, these firms have incentives to leverage information advantage to increase profits at the expense of demand-side stakeholders.

Many services have collective attributes and also are affected by trust problems. Day care for young children has collective attributes that are common to all children in a particular institution (e.g., the educational philosophy); the inability of parents to observe the care given their children, combined with young children's inability to report accurately the care they receive, raises a trust problem. Similar issues arise in the case of hospitals (e.g., the range of services as a collective attribute, and effectiveness of treatment as an attribute that is difficult to monitor). Museums and the performing arts have strong collective attributes (exhibits and productions, respectively), whereas physician services and nursing homes for the elderly are subject to obvious trust problems.

The degree to which collective attributes and trust problems affect demand-side stakeholders' level of satisfaction with for-profit provision varies by individual, across goods and services, and from place to place. For example, some individuals may easily be able to obtain information about how their children are treated in day care, or how effectively a hospital treats a certain disease. Other individuals may not be aware at all of the existence of problems with for-profit provision. The relatively expensive-to-produce collective attribute of theater may pose a problem for demand-side stakeholders in Minneapolis, but not for those in the much larger market of Manhattan. In the case of nursing homes, effective government supervision may alleviate some of the difficulties that may arise with for-profit provision.

Firms that do not pursue profit may be able to alleviate dissatisfaction with for-profit provision, but cannot automatically eliminate any of the problems associated with for-profit provision. After all, the absence of a profit motive does not imply the existence of a specific alternative goal. Nonprofit organizations may pursue goals related to various attributes of a service (its quality, diversity, frequency of provision, price, or the identity of its beneficiaries) in ways that fail to meet the demands of some demand-side stakeholders.⁹¹ Recall that the problem with collective goods is that the

by their brand names and therefore be concerned for their reputations. The Organic Foods Production Act of 1990, 7 U.S.C. §§ 6501-6521 (Supp. III 1991), provides that as of October 1, 1993, it is a federal offense to sell or label an agricultural product as organically produced unless it was certified as such by a state or private agency accredited by the United States Department of Agriculture. Despite the limited penalties for violating the law (up to \$10,000), implementation of the law, expected to commence in early 1995, may eliminate some of the rationale for the existence of consumer cooperatives.

91. For example, a firm may emphasize experimental theater more than demand-side stakeholders care for—even if they are dissatisfied with the paucity of experimental plays in the for-profit sector.

conflict between the goals of providers and demand-side stakeholders engenders lack of trust between the parties, which may lead to inappropriate provision of some nonrival attributes; the problem with trust goods is that providers may take advantage of the inferior information that demand-side stakeholders possess about some attributes. Substituting non-profit goals for profit maximization does not resolve these problems. The nondistribution-of-profit constraint—the prohibition of distribution to directors, trustees, managers, and others associated with organizations enjoying 501(c)(3) status—even if strictly enforced leaves too much room for managers to make programmatic decisions that may not agree with the economic demand of those who are dissatisfied with market provision.

Provision by a firm that does not seek profit, but instead pursues some objectives related to the service it provides to its beneficiaries, therefore does not necessarily represent a complete solution to the problem of demand-side stakeholders who are dissatisfied with for-profit or government provision. Instead, control of the nonprofit organization by these demand-side stakeholders provides the only assurance that the firm will operate according to their economic demand. These demand-side stakeholders who will benefit from the operation of such a firm may be called nonprofit demanders. The firms they control may be called bona fide nonprofit organizations, to distinguish them from nonprofit organizations controlled by other parties.

2. Parties Involved in Supporting and Running Nonprofit Organizations: The Nonprofit Controllers

A bona fide nonprofit organization emerges in response to the quest of nonprofit demanders for better provision of collective and trust goods. Such an organization is controlled by nonprofit demanders, who play the role of owners. Individual nonprofit demanders will become involved in the control of nonprofit organizations if their expected benefits from operating a nonprofit organization, minus their expected costs, exceed the benefits they would receive from relying on the services provided by for-profit firms or government agencies, or from entirely forgoing the service. The essential characteristic of the bona fide nonprofit organization is that it allows those dissatisfied with ordinary market channels to attain direct control over an organization instead of indirect control via the market. This Subsection explores exercise of control in bona fide nonprofit organizations, focusing on the factors that determine who among nonprofit demanders will become nonprofit controllers, and how effective these controllers will be.

Demand-side stakeholders who want to help the homeless, but do not trust a for-profit firm with their donations, may have different ideas about the appropriate way of helping the homeless than does a nonprofit administrator interested in the same broad objective.

Control entails determining a firm's objectives and inducing management and employees to pursue these objectives. For a bona fide nonprofit organization, organizational objectives are linked to the aggregated demands of those nonprofit demanders who signal their dissatisfaction with for-profit provision or a particular good or service. Once a firm has defined its objectives, nonprofit demanders and their representatives must select management, design incentives for them, and monitor their activities. Regardless of who takes these important organizational steps, nonprofit demanders must bear the costs of them *voluntarily*.

Will nonprofit demanders bear these costs? Logically, if the benefits to the nonprofit demanders outweigh the costs, they should be willing to do so. But nonprofit demanders may have individual incentives that lead them not to bear their share of the costs, with the result that the nonprofit form may not be viable, or it will be less effective than it could be. This situation may arise under the familiar free-rider scenario. An individual nonprofit demander analyzes the costs and benefits of acting as a nonprofit controller; if she assumes that other nonprofit demanders will not change their behavior as a result of her action, then she will conclude that the action's benefits will be distributed among all demanders. She is unlikely to bear this cost if her share of the benefit it produces is small.⁹² For example, each demander may ask whether paying higher prices for a theater in the form of voluntary contributions will, in fact, increase the number of productions if the demander's contributions are not matched by other demanders' contributions. Put differently, a demander may hope that others will make contributions that he or she can enjoy in the form of more productions. Each demander thus may prefer not to reveal his or her true demand.

The free-rider problem also affects the exercise of control over management. The problem of shareholders not being involved in control is familiar in the for-profit world, but inactivity on the part of nonprofit demanders has more severe consequences. In order to prevent the concentration of ownership that can occur in for-profit firms, nonprofit organizations do not issue transferable shares, if they issue shares at all. This absence of transferable ownership interests precludes reliance on an important external control mechanism available to for-profit firms: the market for takeovers. This and other external control mechanisms force management to behave in closer accord with the interests of owners in order to reduce the likelihood of transfer to new owners who perceive an opportunity for profit through more effective discipline of management. In nonprofit organizations, management and staff

92. Thus if c is the individual's cost and b is the benefit if the organization operates, then the individual nonprofit demander compares c with b/N , where N is the number of nonprofit demanders. Such an assumption is justified when the actions of all demanders are voluntary, and no other considerations exist. An individual nonprofit demander would compare c with b if he or she assumed that all demanders incurred c , and that the benefit b is produced not once, but N times.

may enjoy considerably more latitude in the pursuit of their own objectives at the expense of the objectives of controlling demand-side stakeholders. Hence direct internal control is crucial in nonprofit organizations.⁹³

The control problems that arise in nonprofit organizations may be alleviated in several ways. Some nonprofit demanders with high demand may individually enjoy benefits from the operation of a nonprofit organization that are so large that they exceed individual costs, even if other demanders do not share in costs. Such individuals do not have incentives to free ride. If there are a sufficient number of nonprofit demanders of this kind, their combined efforts may provide sufficient control over a nonprofit organization.

The problems discussed earlier may also be less serious if individual nonprofit demanders change their expectations of the behavior of other demanders. If an individual nonprofit demander expects her actions to be matched by similar actions, then her individual cost-benefit analysis may be reversed. Such matching behavior may occur when nonprofit demanders can observe each other's actions, and when they have easy means of setting and enforcing common standards of behavior. Additionally, preexisting relations among nonprofit demanders may reduce some of the costs associated with the exercise of control; for example, if nonprofit demanders live in proximity to each other or are affiliated with the same organizations, then the cost of identification will be lower. Social, cultural, and other ties among nonprofit demanders also reduce the free-rider problem. For example, parents who are members of an ethnic association or a religious congregation may discover common needs for a certain type of child care and can restrain attempts at free-riding via social links and cultural familiarity. Members of an association may be able to observe others' contributions and be observed by others. The association or congregation may also act as an agent on behalf of its members in controlling the operation of the day care center. Similarly, in medium-sized cities, a few large firms may employ large numbers of high-income and well-educated professionals; representatives of employers (and their foundations) may act on behalf of employees by participating on the board of directors of a nonprofit organization, taking part in setting its objectives and in controlling its activities, and providing funds for more desirable services.

The conditions described above are met only infrequently, and in many nonprofit organizations only a few nonprofit demanders serve as nonprofit controllers. Absent broad involvement by nonprofit demanders, nonprofit organizations represent a less complete solution to the market failures to which they respond. Low participation may prevent nonprofit formation in the first place, or may allow management a large role in the determination of the organization's objectives. Given the fact that many nonprofit demanders do not

93. See Ben-Ner et al., *supra* note 74.

bear costs, and given the existence of free-rider problems, even high-demand stakeholders are unlikely to exercise their control rights fully.

These two aspects of control failure in nonprofit organizations—insufficient participation in control and insufficient exercise of control by those who do participate—occur when a nonprofit organization's services do not accurately reflect the economic demand. In turn, public good will towards nonprofit organizations may decline.⁹⁴

C. *Reforming Law and Public Policy Towards Nonprofit Organizations*⁹⁵

Nonprofit organizations exist to correct market and government failures. Nevertheless, they tend to be plagued by a major failure—a control failure that stems from the fact that too few nonprofit demanders are also nonprofit controllers. The issues that brought the nonprofit sector to the public eye in the early 1990's—excessive executive compensation and the lack of accountability of management, trustees, and directors—are only examples of this systemic problem of control failure. Policy and legal reform efforts should be directed at remedying this failure.⁹⁶ Two goals should guide these efforts: identifying nonprofit demanders, and helping them become nonprofit controllers.

The main shortcoming of the current framework is the absence of legal provisions for effective governance of nonprofit organizations. The law deals with fiduciary duties of board members, but says nothing about whose objectives they should pursue, whom they should represent, and how they come into their positions. Unlike the laws governing the operation of for-profit firms, the laws governing nonprofit organizations are silent about whom nonprofit organizations should serve. The laws governing for-profit enterprise represent an attempt to support owners of for-profit firms in the exercise of

94. The survival of ineffective nonprofit organizations, dominated by management or by a small minority of the nonprofit demanders, does not suggest that they are optimal, but only that they are the best currently available alternative.

95. There is a sizable literature dealing with law and public policy towards nonprofit organizations. See generally James J. Fishman, *The Development of Nonprofit Corporation Law and an Agenda for Reform*, 34 EMORY L.J. 617 (1985); Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497 (1981) [hereinafter Hansmann, *Reforming*]; Henry B. Hansmann, *The Evolving Law of Nonprofit Organizations: Do Current Trends Make Good Policy?*, 39 CASE W. RES. L. REV. 807 (1988–89) [hereinafter Hansmann, *Evolving*]; Harry G. Henn & Jeffery H. Boyd, *Statutory Trends in the Law of Nonprofit Organizations: California, Here We Come!*, 66 CORNELL L. REV. 1103 (1981); Simon, *supra* note 5.

The recommendations for reform summarized here are discussed in more detail in Avner Ben-Ner & Theresa Van Hoomissen, *The Governance of Nonprofit Organizations: Law and Public Policy*, 4 NONPROFIT MGMT. & LEADERSHIP 393 (1994). The recommendations presented in this Section represent broad ideas for legal reform. Should legal scholars find interest in these ideas, they will certainly have to refine and redefine them in order to create a legal framework that can be implemented. (The present author lacks, perhaps too obviously, a legal education.)

96. Policy intervention can be justified broadly if it can be shown that its costs are low and its benefits are large and relatively widely distributed. A simpler justification may be adduced in favor of a policy that replaces one with higher costs and lower benefits. The policies recommended in this Section probably can be justified on both accounts, but this is beyond the scope of this Review.

their ownership rights vis-à-vis fellow owners, management, and employees.⁹⁷ In similar fashion, nonprofit organizational law and associated policies should support nonprofit demanders in the exercise of their rights to control vis-à-vis other nonprofit demanders, management, and employees. In view of the great differences between for-profit firms and nonprofit organizations, the laws that regulate nonprofit governance should be adapted to the specific needs of nonprofits.⁹⁸

The status of owners of for-profit firms is clearly defined in law; there is no explicit parallel concept, however, for nonprofit organizations.⁹⁹ The most critical step in reforming nonprofit organizational law is to establish a legal status for members, and to link membership to some status of control. The category of nonprofit members should mirror the theoretical concept of nonprofit demanders developed above; members' relative economic demand should be linked to their relative control.

To accomplish these goals, nonprofit organizational law should confer membership upon those individuals and groups who (1) show proof of contributions to the organization in the form of purchases, donations of cash or property, or time volunteered to the organization, and (2) sign a statement of general agreement with the organization's written objectives. Members should have the right to vote in elections for the board of directors and should be able to participate in the ratification of strategic decisions. Each member should have voting power in proportion to his or her contributions to the organization.¹⁰⁰ Every member (or member's representative, when the member is an organization) should also have the right to be elected to the board of directors.

97. For an interpretation of corporate law along similar lines, see FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991).

98. Over the years, as several legal scholars have noted, nonprofit organizational law increasingly has come to resemble for-profit corporate law. See, e.g., Fishman, *supra* note 95; Hansmann, *Reforming*, *supra* note 95; Hansmann, *Evolving*, *supra* note 95; Elizabeth A. Moody, *The Who, What, and How of the Revised Model Nonprofit Corporation Act*, 16 N. KY. L. REV. 251 (1988). Henn and Boyd observe that "[t]he law historically has given nonprofit organizations, like Cinderellas, the hand-me-downs of their half-siblings, the business organizations." Henn & Boyd, *supra* note 95, at 1104.

99. Even in firms in which the identification of owners is easy, such as mutual financial institutions, "members" have few rights that resemble the rights of shareholders in for-profit firms. For example, the lack of recognition of members-depositors in mutual savings and loan institutions allowed management to become *de facto* owners, leading to large transfers of wealth from depositors to management and outsiders who exploited this legal flaw. In addition, many nonprofit organizations, such as public radio stations, refer to their contributors as members. The great majority of these "members," however, have no voting or other rights to influence the objectives of the organization or control its management. A few large contributors presumably hold all decision-making power (unless it is usurped by management) even if their combined contributions represent only a small portion of an organization's revenues. See, e.g., Anna Quindlen, *Quid Pro Quo*, N.Y. TIMES, Oct. 8, 1994, at A17 (claiming that Phillip Morris Company obtained support against antismoking policies from New York City nonprofit corporations it supports).

100. Contributions can include the purchase of services and the value of donations and volunteer time. Also, contributions towards endowments (a stock) should be treated differently from contributions towards operating revenue (a flow). The issue of the control rights of deceased donors will not be tackled in this Review.

Members should have legal standing to sue the organization's directors and managers for taking actions against the interests of members that violate the organization's constitution or bylaws. But members should not be awarded monetary damages. The relief available should consist primarily of changing the organization's policies, removing managers and directors, and forcing managers and directors to pay damages directly to the organization.

Currently, only state attorneys general are permitted to initiate litigation charging management of nonprofit organizations with corruption or mismanagement.¹⁰¹ A few states, such as California and New York, allow members of a few types of nonprofit organizations to bring derivative actions.¹⁰² In recent years, however, courts have been increasingly willing to grant standing to various parties, including beneficiaries.¹⁰³ Yet, the case law has developed without a guiding principle, and court rulings have been inconsistent in identifying who has standing to sue: demand-side stakeholders or beneficiaries who are not demand-side stakeholders.¹⁰⁴ Courts seem to be motivated by a desire to impose some accountability on the management of nonprofit organizations. Thus, granting standing to members offers a solution to problems increasingly acknowledged by courts.¹⁰⁵

The board of directors should be constituted so to allow members a voice in shaping the organization's general objectives and their implementation. The board should be large enough to allow access to it by groups with diverse demands. In addition to members, the nonprofit organization may grant others the right to be elected to the board.¹⁰⁶ Although the board should have broad rights of decision making concerning the organization's policies, radical changes in the objectives of the organization and major structural changes (such as mergers) should be approved by members.¹⁰⁷

101. According to Fishman, *supra* note 95, at 669, directors of nonprofit organizations also have standing to sue.

102. CAL. CORP. CODE §§ 5710, 7710 (West 1990); N.Y. NOT-FOR-PROFIT CORP. LAW § 623 (McKinney 1977); see also Mary Grace Blasko et al., *Standing To Sue in the Charitable Sector*, 28 U.S.F. L. REV. 37, 54 (1993).

103. Blasko et al., *supra* note 102, at 61.

104. See, for example, the granting of standing to students in *Jones v. Grant*, 344 So. 2d 1210 (Ala. 1977), where the Supreme Court of Alabama held that students were beneficiaries and thus had a special interest in the policies of the college they attended. This ruling differs from other rulings that followed the reasoning put forth in the famous Dartmouth College case, *Dartmouth College v. Woodward*, 17 U.S. 518 (1819), denying standing to students.

105. Some commentators claim that standing in court by so many members of the general public will invite frivolous litigation that will swamp the courts. Fishman and Hansmann argue that excessive litigation will not ensue in the wake of such a change. See Fishman, *supra* note 95; Hansmann, *Reforming*, *supra* note 95; Hansmann, *Evolving*, *supra* note 95. Their claims are based partly on the results of Wisconsin's experiment with such a law. In any event, the potential costs of such a law (due to increased litigation) should be compared with the potential improvement in the operation of nonprofit organizations. Blasko et al., *supra* note 102, at 78-81, adduce several useful examples of how standing might be granted (although they do not distinguish members clearly enough from beneficiaries who are not members).

106. For example, some nonprofit organizations may wish to include clients on their boards.

107. The interpretation of "radical changes" should be made by the board. Members should have the right to challenge the board's judgment in court.

The board should be elected every few years and meet relatively infrequently. An executive committee, elected from among the members of the board, should meet frequently and assume responsibility for hiring and firing management and overseeing the organization's policies.¹⁰⁸ The committee should be independent of the organization's executives, although the chief executive officer would sit on this committee (but not on the board) as an *ex officio* member.¹⁰⁹

Members should have the right to access information.¹¹⁰ Each year members should receive the organization's tax return, a statement regarding management and board compensation, data on the total compensation of other employees, information about the largest donations, and quarterly programmatic and financial information. Members should be able to receive upon request (for a fee covering the cost of printing and mailing) the names of members of the board, their committee memberships, and minutes of board and executive committee meetings. This information should be available on the same terms from a state Office on Nonprofit Organizations.¹¹¹

Each nonprofit organization should be required to have a written statement of its goals. While most nonprofit organizations do have mission statements, they are typically extremely vague and noncommittal. A clear statement of goals is needed to establish a point of reference for members to judge the performance of directors and management and to provide a basis for legal suits for violations of an organization's mission. This statement of goals can be amended by an organization's membership.¹¹²

Current federal and state policies and laws do help nonprofit organizations' governance in some respects: Laws require that nonprofit firms make certain financial information available to the public, hold directors and trustees to fiduciary standards, and establish the nondistribution-of-profit constraint. The IRS is the primary enforcer of the nondistribution-of-profit constraint, and state attorney general offices are in charge of enforcing compliance with standards of fiduciary behavior by members of boards of directors and by trustees (and more recently, by managers).¹¹³ The nondistribution-of-profit constraint limits the granting of excessive compensation to executives and helps prevent the use of the nonprofit form as a disguise for for-profit activity. The targets of attorney general lawsuits usually are directors and trustees suspected of

108. Fishman, *supra* note 95, proposed a bifurcated board structure, which is similar to the board and executive committee structure.

109. Small nonprofit organizations may substitute an annual meeting for the board, and elect directly the executive committee at that meeting.

110. A similar point is made in Hansmann, *Reforming*, *supra* note 95.

111. See *infra* note 115 and accompanying text.

112. Note that for-profit firms have a simple statement of goals, maximization of shareholder wealth. Shareholders can sue management for violation of this goal.

113. See Marion R. Fremont-Smith, *Trends in Accountability and Regulation of Nonprofits*, in *THE FUTURE OF THE NONPROFIT SECTOR* 75 (Virginia A. Hodgkinson et al. eds., 1989).

violating fiduciary standards, mostly by engaging in self-dealing. Some state attorneys general attempt to enforce laws and regulations concerning nonprofit organizations' charitable purpose by imposing requirements regarding the composition of boards or trustees.¹¹⁴ Nonetheless, there is only limited oversight over the tax returns of nonprofit organizations and over their day-to-day operations. Weak enforcement is structural: The IRS and state attorneys general cannot know enough about the internal operation of individual organizations to be effective enforcers of the nondistribution-of-profit constraint.

In order to improve the state's role in enhancing the operation of nonprofit organizations, each state should establish an Office on Nonprofit Organizations (ONO), building on resources currently found in attorney general offices, Charitable Organization Registrars, and similar agencies.¹¹⁵ ONOs will complement the control and information-providing functions of the IRS. The ONOs should help nonprofit organizations identify nonprofit demanders, educate them for effective participation in governance, and encourage their active involvement—that is, help them to become nonprofit controllers. In addition, they should provide mediation services for members with complaints against the board or management of their organizations and, if necessary, guidance in bringing legal action. ONOs should also collect and disseminate information about important financial and programmatic aspects of nonprofit organizations, as well as about members' activities, thus creating a pool of statistical data about the nonprofit sector for the benefit of members who want to understand and compare practices in different organizations.

Finally, in order to prevent situations in which nonprofit organizations come under the control of management or a small subset of members, ONOs should act as members-of-last-resort by casting votes in nonprofit organizations in which members provide only a small minority of contributions, or where participation in voting is extremely low. ONOs should explain in writing their voting decisions and will submit a plan to the organization affected by the vote with suggestions on how to improve member involvement.

The type of membership structure defined above allows demand-side stakeholders—those who truly care about an organization and have an economic demand for the nonprofit form—to become involved in the control of nonprofits. Because the strength of the demand for the nonprofit form is positively related to a demand-side stakeholder's contributions to the

114. Massachusetts seems to be among the more active states, negotiating agreements with a few organizations after officers or trustees of these organizations were accused of receiving illegal compensation. The agreements require the addition of members to the board through voting by alumni of a university or by cooperation of individuals who belong to certain socioeconomic groups.

115. The ONO proposed here resembles Karst's "State Board on Private Charities." See Kenneth L. Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433 (1960). Karst discusses various measures necessary to ensure the independence of such an agency from powerful parties frequently associated with boards of directors of nonprofit organizations.

organization, allocating votes based on these contributions strengthens the standing of nonprofit demanders vis-à-vis management by drawing an explicit link between expressed demand and the extent of participation in control.¹¹⁶ Individuals and organizations that would like to become members in order to sabotage an existing organization's objectives will not only have to lie (and thus violate the law) when they assert general agreement with the organization's written objectives, but will have to make significant contributions to the organization in order to obtain any influence.¹¹⁷

III. CONCLUSION

Who Benefits from the Nonprofit Sector? finds that it is not the poor who are the primary beneficiaries of the varied activities of the nonprofit sector. Putting aside the idea that the nonprofit sector exists to perform charity, this Review suggests that the nonprofit sector exists for a different reason: to correct market and governmental failures that affect some consumers, donors, and sponsors of certain services, and to satisfy their demand for an alternative type of organization. In turn, a supply of nonprofit organizations is made possible by a subset of demand-side stakeholders who have both greater demand and better ability to create and operate such organizations.

The primary mechanism that enables nonprofit organizations to correct market and governmental failures is control by those with an economic demand for nonprofits—those who are interested in an organization's output and are willing and able to support it financially. Many nonprofit organizations, however, suffer from "control failure" when demand-side stakeholders either fail to engage in control or exercise insufficient control. Control failure stems from the inability or free-rider-induced unwillingness of nonprofit demanders to participate effectively in control and from the exclusionary practices of those who appropriate control, whether they are customers, donors, sponsors, or managers. Nonprofit control failure can lead nonprofit organizations to provide services based on the preferences of those who control them, leading others to patronize the organization less than they otherwise would have, or to leave it entirely.

116. It bears repeating that demand-side stakeholders in general and nonprofit demanders in particular, and therefore nonprofit organizations' members, do not include those who serve as the primary beneficiaries of an organization, for reasons detailed in Part I.B. This does not, however, prevent members from allocating seats on the board of directors or otherwise involving in governance any number of such beneficiaries. Demand-side stakeholders who donate resources to benefit the homeless, for example, will likely seek the best ways to attain this objective. This may include turning over some decision-making rights in the organization to the homeless. On the other hand, those who wish to contribute towards a certain goal but oppose clients' participation in decision making will withhold their (voluntary) contributions should such participation be legislated.

117. Moreover, such members will have to expose themselves if they want to propose drastic changes in the objectives of the organization, thus risking expulsion from the organization and a lawsuit against them.

Policy towards nonprofit organizations should target the customers, donors, and sponsors. This perspective leads to a different focus than that in *Who Benefits from the Nonprofit Sector?*, because this view shifts the emphasis to those with an economic demand for the services affected by market or government failure. The approach advocated here does not suggest that nonprofit organizations necessarily will have an orientation that favors the poor, although it identifies the activities that rely heavily upon contributions as important areas of possible market failure and therefore areas of potentially significant nonprofit activity. In addition, because many redistributive activities involve collective goods and trust problems, they represent prime candidates for market and governmental failure.

The theory put forth in this Review also implies that nonprofit status should not be conditioned on the pursuit of particular charitable goals. Nor should nonprofit organizations receive tax benefits and other subsidies solely because of their form of incorporation. Instead, only services deemed worthy of public support should be accorded such advantages. The legal framework proposed here would bring only bona fide nonprofit organizations within the reach of nonprofit organizational law.

Recent media revelations about some of those who benefit unjustly from the nonprofit sector and the publication of *Who Benefits from the Nonprofit Sector?* surely will strengthen the calls for a reevaluation of law and public policy towards nonprofit organizations. A revision of the Model Nonprofit Corporation Act,¹¹⁸ changes to federal laws that govern nonprofit organizations, and a shift in policies that affect their economic well-being should be guided not by unfounded expectations about the charitability of the nonprofit sector but by a theory that explains the existence of nonprofit organizations in a mixed economy. Nonprofit organizational law should afford demand-side stakeholders of nonprofit organizations—consumers, donors, and sponsors—direct rights of control and should support the exercise of those rights just as laws governing for-profit organizations recognize and support the rights of the owners of for-profit firms. Some of those who currently control nonprofit organizations may lose control under the proposed structure. In response, those controllers may transform their organizations into some variant of a for-profit firm. Only by allowing the principles that account for the nonprofit sector's existence to drive the operation of nonprofit firms can we benefit both the sector itself and society as a whole.

118. REVISED MODEL NONPROFIT CORP. ACT (1987).