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ALTRUISM IN NONPROFIT ORGANIZATIONS†

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I. INTRODUCTION

Between the well-charted domains of for-profit firms and modern government lies what was until recently a virtual terra incognita. Early explorers labelled this middle ground "the Third Sector," reflecting their recognition that they were in a distinctive sphere. But their recognition was largely intuitive. The Third Sector was said to be inhabited by a congeries of tribes who acknowledged fealty to neither Caesar nor the Invisible Hand, who were accountable in neither the arena of politics nor the marketplace of economics. Systematic study of this sector's inhabitants, known collectively as nonprofits, lagged behind that of their neighbors on the governmental and for-profit sides.¹

¹ After I had written this paragraph, a quotation in J. VAN TIL, *MAPPING THE THIRD SECTOR: VOLUNTARISM IN A CHANGING SOCIAL ECONOMY* 71 (1988) led me to very similar language in COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS, *GIVING IN AMERICA: TOWARD A STRONGER VOLUNTARY SECTOR* 31 (1975) [hereinafter *FILER COMMISSION REPORT*].

Recently, however, this has begun to change. In the last decade or so, a new generation of explorers, equipped with the insights of contemporary social science, have sought to penetrate the mysteries of the Third Sector.² Demographers have surveyed its inhabitants,³ cartographers have mapped its contours,⁴ and a host of empirical studies have described the cultures of particular precincts.⁵ Building on these studies,⁶ other scholars have attempted, at a more Toyn-beean level of generality, to erect theories explaining why nonprofits evolve and how they behave once they appear.⁷

As a result, we now have several theories, complementary at some points and conflicting at others, of the internal organization and operation of nonprofits.⁸ We also have a detailed and widely-

Though, as the title of Van Til's book suggests, the general cartography metaphor has passed into common usage, the specific language of the Filer Commission Report is sufficiently close to mine to warrant separate acknowledgment.

It is possible to identify a fourth sector, the "household" or "informal" sector. See J. VAN TIL, *supra*, at 87. The presence of this sector is implicit in my discussion in section IV of the need for altruism to take institutional forms, and warrants explicit discussion in connection with the tax exemption of mutual benefit organizations. See *infra* notes 343-54 and accompanying text for a discussion of the relationship between mutual benefit organizations and household production.

² In some respects the watershed year was 1975. In December of that year, the Commission on Private Philanthropy and Public Needs published its report and recommendations. See FILER COMMISSION REPORT, *supra* note 1. The Commission's research papers, which were published in 1977 in collaboration with the Treasury Department, not only "provided scholars and policymakers with a baseline knowledge, circa the mid-1970s, of the scope and operations of the nonprofit sector," THE NONPROFIT SECTOR xi (W. Powell ed. 1987) [hereinafter THE NONPROFIT SECTOR]; they also laid the foundation for analysis of the nonprofit sector's role and offered specific proposals for law reform.

Another significant impetus to the study of nonprofits came in 1976, when the Program on Non-Profit Organizations was established under the auspices of the Institute for Social and Policy Studies at Yale. It was the first of several university-affiliated interdisciplinary programs devoted to the study of nonprofits.

³ The demographic accounts in the FILER COMMISSION RESEARCH PAPERS appear primarily in Volume 1, *History, Trends, and Current Magnitudes*. See 1 COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS, RESEARCH PAPERS (1977) [hereinafter FILER COMMISSION PAPERS]. For a more recent survey, see Rudney, *The Scope and Dimensions of Nonprofit Activity*, in THE NONPROFIT SECTOR, *supra* note 2, at 55.

⁴ See, e.g., J. VAN TIL, *supra* note 1.

⁵ See, e.g., 2 FILER COMMISSION PAPERS, *supra* note 3; Hansmann, *Economic Theories of Nonprofit Organization*, in THE NONPROFIT SECTOR, *supra* note 2, at 27 (citing pre-Filer Commission studies in the health care industry).

⁶ For a brief account of the development of general theories from particular industry studies, particularly those in the area of health care, see Hansmann, *supra* note 5.

⁷ In distinguishing between theories that account for the role of nonprofits and those that account for their behavior, I am following Hansmann, *supra* note 5, at 27-28.

⁸ For a survey of these "behavior" theories, see Hansmann, *supra* note 5, at 37-40. See also E. JAMES & S. ROSE-ACKERMAN, *THE NONPROFIT ENTERPRISE IN MARKET ECONOMICS* (1986). To the extent that these theories address a common issue beyond the behavior of

accepted account that explains why nonprofits evolve in the ecological niche they occupy in the western, and particularly the American, institutional landscape. The emerging orthodox account of the role of nonprofit organizations is aptly dubbed the twin failure theory.⁹ It describes nonprofits as a response to social and economic challenges beyond the capabilities of for-profit firms on the one hand and government on the other.¹⁰ Though the two halves of the twin failure theory — market failure and government failure — were developed separately, together they give a plausible and coherent account of the Third Sector. It is, however, an incomplete account. Moreover, its omissions limit its utility as a tool for policy makers and make it a potentially dangerous instrument in the hands of those who would cut back government policies favoring nonprofits.

When fertile lands are discovered or rediscovered, the interest they arouse is seldom exclusively scholarly. The Reagan administration early on sought to enlist increased aid from the Third Sector as government's traditional ally in combatting social ills on a variety of fronts.¹¹ Some say that the federal government's unilateral disarmament on several of these fronts has wrought dramatic changes in the nonprofit sector since 1980. According to this view, the Reagan Revolution's retrenchment in many areas of social service that were long reinforced, if not occupied, by the public sector has sent significant numbers of refugees to the nonprofit sector. Serving these refugees has seriously depleted the traditional resources of the nonprofit sector and has forced organizations in that sector to find alternative sources of supply, innovative ways to generate necessary revenue.¹²

nonprofits, it is what nonprofits maximize in the absence of incentives to produce net revenues for equity owners.

⁹ See J. DOUGLAS, *WHY CHARITY?* 160 (1983).

¹⁰ I deal later with the market failure theory, see *infra* notes 33–63 and accompanying text, and the government failure theory, see *infra* notes 206–20 and accompanying text.

¹¹ The leading study of these developments is L. SALAMON & A. ABRAMSON, *THE FEDERAL BUDGET AND THE NONPROFIT SECTOR* (1982). Salamon and Abramson describe the avowed Reagan objective of federal retrenchment, see *id.* at 21–22, and the traditional governmental/nonprofit partnership in many areas of social service, see *id.* at 22–24. In W. NIELSEN, *THE GOLDEN DONORS: A NEW ANATOMY OF THE GREAT FOUNDATIONS* 48–50, 54 (1985) the author argues that the voluntarism rhetoric of the first Reagan term was dropped and forgotten in the second. Perhaps something of an afterglow is left in President Bush's "thousand points of light." For an unsympathetic analysis of the ideology informing the Reagan administration approach to the Third Sector, see J. VAN TIL, *supra* note 1, at 44–45, 46–47.

¹² Salamon and Abramson predicted this development on the basis of proposed Reagan administration budget cuts in areas where nonprofits either relied on direct government funding or could reasonably be expected to experience increased demand for their services

Nonprofits have shown great imagination and have met with considerable success in seeking these new sources of revenue.¹³ Unfortunately, however, these successes have occasionally been in areas of endeavor that some elements of the for-profit sector claim as their exclusive spheres of influence. Nonprofits' enterprising activities frequently involve provision of goods and service in competition with for-profit suppliers. Decrying these incursions, aggrieved for-profits have rallied under the banner of "unfair competition," and have enlisted allies in the executive¹⁴ and legislative¹⁵

when government provision was reduced. L. SALAMON & A. ABRAMSON, *supra* note 11, at 57-66. Subsequent events have tended to confirm their predictions, except as to some aspects of health care. Salamon, *The Results Are Coming In*, FOUND. NEWS, Jul.-Aug. 1984, at 16-23; Salamon and Abramson, *Nonprofits and the Federal Budget: Deeper Cuts Ahead*, FOUND. NEWS, Mar.-Apr. 1985, at 48-54. Skloot, *Enterprise and Commerce in Nonprofit Organizations*, in THE NONPROFIT SECTOR, *supra* note 2, at 380, notes that "[t]he scope and magnitude of enterprise activities in the nonprofit sector has expanded greatly," for reasons that include the Reagan administration's budget cuts in areas of traditional nonprofit activity and that administration's persistent calls for "self-reliance" by nonprofit organizations.

For a discussion of nonprofits' enterprising activities, see J. CRIMMINS & M. KEIL, ENTERPRISE IN THE NONPROFIT SECTOR (1983); Skloot, *supra*; Troyer & Boisture, *Charities and the Fiscal Crisis: Creative Approaches to Income Production*, in NEW YORK UNIVERSITY, THIRTEENTH CONFERENCE ON CHARITABLE ORGANIZATIONS §§ 4.01-.04 (1983).

¹³ Troyer & Boisture, *supra* note 12, at §§ 4-1 to 4-31. Skloot identifies several broad areas of nonprofit entrepreneurial activity. See Skloot, *supra* note 12, at 381-83. He also discusses several successful examples in detail. See *id.* at 383-87. Nonprofit enterprising activity does, of course, present financial and other pitfalls for particular organizations and for the nonprofit sector as a whole. *Id.* at 381, 387-90; see also Troyer & Boisture, *supra* note 12 (discussing financial risks and possible adverse effects on charitable programs and exemption status).

¹⁴ See, e.g., OFF. OF ADVOC., U.S. SMALL BUS. ADMIN., ISSUE ALERT: UNFAIR COMPETITION WITH SMALL BUSINESS (1986); OFF. OF ADVOC., U.S. SMALL BUS. ADMIN., UNFAIR COMPETITION BY NONPROFIT ORGANIZATIONS WITH SMALL BUSINESS: AN ISSUE FOR THE 1980s (1984).

¹⁵ See *Unrelated Business Income Tax: Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means*, 100th Cong., 1st Sess. 2 (1988) [hereinafter *Pickle Hearings*]. Citing for-profit firms' complaints about unfair competition and the Small Business Administration's concerns on that score, Rep. Rostenkowski, Chair of the House Ways and Means Committee, requested the Subcommittee on Oversight "to conduct a comprehensive review of the Federal tax treatment of commercial and other income-producing activities of organizations that have tax exemption under section 501 of the Internal Revenue Code." *Id.* at 2. In his announcement of hearings on that subject, Rep. Pickle, Chair of the Subcommittee on Oversight, pledged "a full and fair hearing on all the issues involved." *Id.* at 5. But the impetus for the hearings clearly came from disgruntled elements of the for-profit sector, and the outline of issues in Rep. Rostenkowski's original notice left no doubt that the central question was whether exempt organizations should be subject to further taxation.

As one witness at the hearings said elsewhere, "The truly difficult and important issue involving the tax treatment of nonprofits concerns not the UBIT [unrelated business income tax] but rather the scope of the basic exemption that underlies it, and that is where future debate should focus." Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VA. L. REV. 605, 635 (1989). As a practical matter, the questions of exemption and UBIT can be collapsed into each other, in either of two ways. With a sufficiently broad view of

branches of government in a campaign to re-examine federal policies that benefit nonprofits, particularly in matters of taxation.¹⁶ Advocates for for-profits maintain that current federal policies give nonprofits unfair competitive advantages in the same revenue-generating activities in which for-profits engage. The most frequently stated objective of the unfair competition crusade is to restore and police the traditional boundary between for-profits and nonprofits, a boundary defined with greatest particularity in federal tax law but evident in other areas as well.¹⁷ There is at least some evidence, however, of a desire to roll back the traditional frontier and annex territory once widely acknowledged to be in the heartland of the Third Sector.¹⁸ And it is not overly cynical to suggest that some

exempt purposes, the issue of unrelated income never arises. This was in effect what happened under the pre-1950 destination of income test—devoting income from any source to identifiable charitable purposes was itself treated as a charitable purpose. *Trinidad v. Sagrada Orden*, 263 U.S. 578 (1924); *Roche's Beach, Inc. v. Commissioner*, 96 F.2d 776 (2d Cir. 1938). On the other hand, if one assumes that the purpose of the UBIT is to eliminate "unfair competition" and then defines "unfair competition" broadly enough, the UBIT swallows up the tax exemption for charity. This would be the logical result, for example, of arguing that the tax exemption itself gives charities an unfair competitive advantage against for-profits providing the same products. See *infra* note 359 and accompanying text for the argument that granting exemption only to nonprofits is unfair. For a brief description of the basic forms of nonprofit income, see text accompanying note 277.

¹⁶ For a survey of the early skirmishes, see S. PIRES, *COMPETITION BETWEEN THE NON-PROFIT AND FOR-PROFIT SECTORS: A SPECIAL REPORT OF THE NATIONAL ASSEMBLY OF NATIONAL VOLUNTARY HEALTH AND SOCIAL WELFARE ORGANIZATIONS* 16-17 (1985).

¹⁷ Other areas in which nonprofits enjoy advantages include Social Security, 42 U.S.C. § 410(a)(8)(B) (1988); unemployment insurance, *id.* § 3306(b)(5)(A), (c)(8); minimum wage, 29 U.S.C. § 203(r) (1988) & 29 C.F.R. 779.214 (1989); securities regulation, 15 U.S.C. § 77c(a)(4) (1988), 11 U.S.C. § 303(a) (1988); antitrust, *Marjorie Webster Junior College v. Middle State Ass'n of Colleges & Secondary Schools*, 432 F.2d 650 (D.C. Cir.) (applying loose antitrust standards to organizations with "noncommercial" objectives), *cert. denied*, 400 U.S. 965 (1970); unfair competition, 15 U.S.C. §§ 44, 45 (1988); copyright, 17 U.S.C. §§ 110, 111(a)(5), 112(b), 118(d)(3) (1988); and postal rates, 39 U.S.C. § 3626 (1988) (defining favored mailers by reference to former code, 39 U.S.C.S. §§ 4358, 4359(d), (j)(2) (Law. Co-op. 1967 & Supp. 1978)). These areas are identified at Hansmann, *The Role of Nonprofit Enterprise*, 89 *YALE L.J.* 835, 836-37 (1980).

In several instances, the favored organizations are defined by reference to categories of organizations exempt from federal income taxation. See 42 U.S.C. § 410(a)(8)(B) (1988); *id.* § 3306(b)(5)(A), (c)(8); 29 U.S.C. § 203(4) (1988) & 29 C.F.R. 779.214 (1988); 15 U.S.C. § 77c(a)(4) (1988); 39 U.S.C. § 3626 (1988).

¹⁸ See, e.g., Tax Reform Act of 1986, Pub. L. No. 99-514, § 1012(a), 100 Stat. 2085, 2390-91 (adding current I.R.C. § 501(m) (1988), which denies charitable status under section 501(c)(3) and social welfare organization status under section 501(c)(4) to organizations like Blue Cross and Blue Shield that provide "commercial-type insurance"); SUBCOMMITTEE ON OVERSIGHT, HOUSE COMMITTEE ON WAYS AND MEANS, ANNOUNCEMENT OF SUBCOMMITTEE REQUEST FOR PUBLIC COMMENTS ON DISCUSSION OPTIONS RELATING TO THE UNRELATED BUSINESS INCOME TAX, PRESS RELEASE NO. 16 (March 31, 1988) (listing as "discussion options" dramatic changes to scope of unrelated business income tax, including replacement of "sub-

members of Congress would be willing to cede parts of the formerly tax exempt nonprofit sector to for-profit firms in return for the tribute of additional tax revenue.

In this campaign to re-examine federal policies favoring nonprofits, especially federal tax policies, scholarly exponents of the market failure theory of nonprofits have offered support to the irredentist claims of the business community.¹⁹ In part, this is because the market failure theory describes nonprofits as emerging naturally in an environment to which many would like to see them, or at least their favorable tax treatment, confined. What is, of course, is not necessarily what ought to be.²⁰ Even if, as a matter of fact, nonprofits tend to arise and thrive in particular industries in the way that orthodox theory describes, it would not necessarily follow that they should be confined to those industries. Nor would it follow that they should be denied favorable status under various bodies of federal law when they operate outside those industries.

Orthodox theory does, however, purport to bridge this gap between the "is" and the "ought." Complementing the orthodox descriptive theory of the evolution of nonprofits is a normative theory of why nonprofits should be indirectly subsidized through the exemption of their revenues from federal income taxation. In barest outline, orthodox theory holds that, under the particular failures of the market economy that tend to give rise to nonprofit organizations, those organizations perform more efficiently than alternative for-profit suppliers.²¹ Unfortunately, however, their very nonprofit nature bars their access to equity capital markets as a source of funds for growth. They thus tend not to expand at what economic analysis suggests is the optimal rate for allocative efficiency. This inherent impediment is relieved, though only indirectly

stantially related test" with "directly related test" and application of tax to "inherently commercial" activities).

¹⁹ See *Pickle Hearings*, *supra* note 15, at 1835 (statement of Henry Hansmann) ("careful economic analysis in fact supports the conventional wisdom of the business community: the UBIT [Unrelated Business Income Tax] helps to assure that nonprofit firms do not have an undesirable competitive advantage in providing services that can be provided as well or better by for-profit firms").

²⁰ The difficulty, if not impossibility, of deriving the latter from the former is well documented in the literature on the "naturalistic fallacy." See, e.g., D. HUME, *PRINCIPLES OF MORALS* 125-36 (Open Court Pub. Co. 1953, reprinted from 1777 ed.); D. HUME, *TREATISE OF HUMAN NATURE*, Book III, Part I, Section I; G.E. MOORE, *PRINCIPIA ETHICA* 10-36 (1903); Prichard, *Does Moral Philosophy Rest on a Mistake?*, in *MORAL OBLIGATION* (1949); *THE IS- OUGHT QUESTION—A COLLECTION OF PAPERS ON THE CENTRAL PROBLEM IN MORAL PHILOSOPHY* (W.D. Hudson ed. 1969).

²¹ For a fuller outline, see *infra* notes 281-89 and accompanying text.

and rather crudely, by exempting their net revenues from federal income taxation, thus increasing their pool of retained earnings available for expansion.

So stated, the market failure theory of the federal tax exemption hardly seems a likely weapon in the campaign to put nonprofits back on the reservation by restricting the scope of tax-exempt activities. Because the orthodox theory confirms, rather than denies, favored treatment of nonprofits in some areas, for-profit revanchists seem at risk of being hoist with their own petard. Two points defuse this danger. First, the forms of market failure that orthodox theory give as both the *raison d'être* of nonprofits and the basis of their tax exemption arguably do not exist in several industries in which nonprofits are currently being charged with unfair competition. Second, and somewhat more ambivalently, orthodox theory suggests that nonprofits should not enjoy tax exemption of revenues earned in these areas, because encouraging their presence in these areas will not promote — indeed, tends to undermine — allocative efficiency. The orthodox theory, therefore, provides a cogent rationale for the existence of a tax exempt nonprofit sector, but strongly implies a substantial reduction of its traditional frontiers. It is as if England acknowledged Argentine claims to the Falklands, but only as to lands too rocky for sheep.²²

In this article I suggest a different drawing of the boundary between for-profits and nonprofits, and a correspondingly different rationale for exempting the latter from federal income taxation. I build, as all work in this area must, on the findings of those who have mapped out the orthodox twin failure theory of the nonprofit sector. Indeed, I find that the terrain covered by the economically-oriented orthodox theory most certainly lies within the scope of the nonprofit sector, both as a matter of fact and as a matter of sound policy. Moreover, I acknowledge as correct much of the orthodox explanation of why this terrain does and should belong to the nonprofit sector.

The problem with the orthodox theory is not that it is erroneous, but that it is incomplete, and incomplete on both its descriptive and its normative sides. On the descriptive side, orthodox theory's reliance on the perspective of neo-classical economics leads it to overlook altruism, which I take to be the continental divide in the nonprofit sphere. The benefits provided by organizations on

²² If the harshness of the metaphor strains credulity, see *infra* note 286, indicating that the proper sphere of tax exempt nonprofit activity is where no profit is in fact possible.

one side of the divide flow to their members in the form of ordinary consumer goods and services purchased at fair market value; the organizations on this side of the nonprofit range are mutual benefit nonprofits. I maintain that all other organizations that are truly nonprofit exhibit altruism in one form or another.²³ Altruism, I shall try to show, operates in many of the areas where orthodox theory predicts that nonprofits will evolve. Indeed, it is difficult to understand how nonprofits would arise in these areas were it not for the kinds of altruism I identify. Altruism, however, also gives rise to nonprofit firms in areas other than those that orthodox theory would predict. I argue that there is in principle no good or service that an altruistic organization cannot provide.

This raises the normative question: should nonprofits be encouraged to arise and operate in areas other than those in which the orthodox theory predicts they will be the most efficient suppliers? Orthodox theory says no. It implicitly assumes that the essential function of nonprofit organizations is to remedy a particular form of market failure and that nonprofits are to be encouraged only as a means of addressing that problem. From this it follows that the sole criterion of federal tax exemption of nonprofits is the promotion of economic efficiency. Extrapolating from traditional theories of the role of charities and the rationale for their exemption from federal income taxation, I maintain that viewing altruistic nonprofits as mere adjuncts to the market supply of goods and services overlooks their distinctive function, the altruistic supply of goods and services. In turn, this distinctive function provides a broader rationale for the tax exemption of altruistic organizations' revenues than does either the orthodox theory or existing tax law.

My normative discussion is limited to the policy bases for the federal tax exemption of nonprofits, particularly altruistic non-

²³ I here describe altruistic organizations as the residual category of nonprofits; all nonprofits that are not mutual benefit organizations are altruistic organizations. Logically, the converse is also true: mutual benefit organizations are those nonprofits that are not altruistic. I subordinate altruistic organizations for definitional purposes at this point in the introduction because, as we shall see in section III, the concept of altruism is harder to state in a few words.

In the remainder of the paper, the primary focus is on altruistic organizations, and mutual benefit organizations are treated as the residual category. My discussion of mutual benefit nonprofits is offered primarily to suggest how my account of altruistic organizations would fit into a fuller account of the entire nonprofit realm in terms of the recipients of the benefits that nonprofit organizations provide. The fairly short shrift I give mutual benefits is by no means meant to suggest that they are somehow less practically important or less theoretically interesting than altruistic nonprofits.

profits. Normative questions about the proper treatment of nonprofits arise in many contexts, but their status under the federal income tax code is especially important.²⁴ From the perspective of nonprofits themselves, the exemption of their income from taxation is obviously a considerable advantage. The organization may retain, for the advancement of its own purposes, the part of its revenues that would otherwise be paid to the federal government as taxes. Moreover, nonprofits that fall within the charitable category of tax exempt organizations are entitled not only to have their own income exempt from taxation, but also to entice donors with the prospect of tax-deductible contributions.²⁵ From the perspective of the federal government, the potential erosion of the tax base through abuse of exemption status and contribution deductions creates an incentive both to define the boundaries of exemption carefully and to police those frontiers scrupulously.²⁶ Perhaps because most states lack so large an interest, many have essentially abdicated their traditional role of regulating nonprofits, particularly charities, to the federal government.²⁷ Because the role of federal tax law thus looms so large, the normative aspect of this article will focus on the public policy issues involved in the federal tax treatment of nonprofits, particularly altruistic nonprofits.²⁸

²⁴ See *supra* note 17 for a list of the other areas in which nonprofits enjoy special treatment.

²⁵ I.R.C. § 170 (1988).

²⁶ For the source of this border patrol metaphor, and more on the importance of the reality it describes, see Simon, *The Tax Treatment of Nonprofit Organizations: A Review of Federal and State Policies*, in *THE NONPROFIT SECTOR*, *supra* note 2, at 89-94 ("The Border Patrol Function of Nonprofit Tax Law").

²⁷ See generally Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433 (1960) (urging creation of separate state agencies to supervise charities); Office of the Ohio Attorney General, *The Status of State Regulation of Charitable Trusts, Foundations, and Solicitations*, in 5 FILER COMMISSION PAPERS, *supra* note 3, at 2705, 2706 (1977) ("A majority of states do practically nothing in fulfilling their obligation to the public of safeguarding the billions of dollars controlled by charitable trusts and foundations in this country.").

²⁸ It is important to bear in mind, however, that different policy considerations may counsel in favor of different treatment for other purposes. See, e.g., E. JAMES & S. ROSE-ACKERMAN, *supra* note 8, at 88-89 (concluding that general exemption of nonprofits from real property taxation lacks a strong policy justification); Ginsberg, *The Real Property Tax Exemption of Nonprofit Organizations: A Perspective*, 53 TEMP. L.Q. 291, 322 n.95 (1980) (noting that "the issues surrounding ad valorem taxation are sometimes not analogous to those arising from the taxation of income . . ."); Kielbowicz & Lawson, *Reduced-Rate Postage for Nonprofit Organizations: A Policy History, Critique, and Proposal*, 11 HARV. J.L. & PUB. POL'Y 347, 401 n.317 (1988) (suggesting that some "distortions" in postal policy toward nonprofits may be the result of "entanglement with tax policy"); Sacks, *The Role of Philanthropy: An Institutional View*, 46 VA. L. REV. 516, 532 (1960) ("What may be charitable for purposes of exemption

Section II sets out the market failure theory of the role of nonprofits.²⁹ Section III focuses on the role of altruism in nonprofits and divides nonprofits into ten types, nine of which embody altruism in one form or another.³⁰ Section IV shows how altruistic organizations offer significant advantages over individual altruism, particularly in achieving economies of scale and continuity over time, advantages that are not available through either for-profit firms or government.³¹ Finally, in Section V, I turn to the normative question of whether altruistic nonprofit organizations should be granted federal income tax exemption.³² After analyzing several theories of that exemption, including one derived from the market failure theory of nonprofits, I present the possibility of a synthesis that would exempt the income of altruistic nonprofits as a means of subsidizing the altruistic provision of goods and services without regard to the character of the goods and services provided.

II. THE EMERGING ORTHODOXY — HANSMANN'S THEORY OF THE ROLE OF NONPROFIT ORGANIZATIONS

The chief architect of the market failure side of the emerging orthodox theory of nonprofit organizations is Henry Hansmann. Hansmann sets out his theory in a seminal article, the subtlety and significance of which are hard to over-estimate.³³ Hansmann begins

from the rule against perpetuities need not be so considered for purposes of tax benefits" (footnote omitted)); Note, *Preferential Treatment of Charities Under the Unemployment Insurance Laws*, 94 YALE L.J. 1472 (1985) (questioning favored treatment of charities under the Federal Unemployment Tax Act).

²⁹ See *infra* notes 33–63 and accompanying text.

³⁰ See *infra* notes 64–187 and accompanying text.

³¹ See *infra* notes 188–276 and accompanying text.

³² See *infra* notes 277–380 and accompanying text.

³³ Hansmann, *supra* note 17, at 840–43. Even his critics acknowledge his pre-eminence. See, e.g., Ellman, *Another Theory of Nonprofit Corporations*, 80 MICH. L. REV. 999 (1982) ("[Hansmann's] two lengthy articles dominate the field and establish the topics for discussion."). And his audience is not limited to academics. See *Pickle Hearings*, *supra* note 15, at 1835 (statement of Henry Hansmann).

A roughly contemporaneous, but much briefer, account of nonprofit organizations in terms of the monitoring difficulties encountered by their patrons and the compensating assurance given patrons by the nonprofit form appears in Thompson, *Charity and Nonprofit Organizations*, in *ECONOMICS OF NONPROPRIETARY ORGANIZATIONS* 125, 133–35 (K. Clarkson & D. Martin ed. 1980). Another early account of nonprofits in terms of agency problems is Fama & Jensen, *Agency Problems and Residual Claims*, 26 J. L. & ECON. 327 (1983).

On the foundation of Hansmann's work, Easley and O'Hara have erected a formal model of the nonprofit firm as an optimal contract between firm managers and society. See Easley & O'Hara, *Optimal Nonprofit Firms*, in *THE ECONOMICS OF NONPROFIT INSTITUTIONS* 85 (S. Rose-Ackerman ed. 1986); Easley & O'Hara, *The Economic Role of the Nonprofit Firm*, 14

by identifying the essential characteristic of nonprofit organizations, the fact that they are barred from distributing their net earnings to those who control them, that is, to their members, officers, directors, or trustees.³⁴ As Hansmann notes, this prohibition does not preclude payments for goods or services provided to the organization, even by those who control it.³⁵ Nor does it preclude the organization from having an excess of revenues over its expenditures for such goods and services. Showing a net profit in this sense is not inconsistent with being a nonprofit organization, and many nonprofits do show such surpluses. Rather, "[i]t is only the distribution of the profits that is prohibited." Or, stated affirmatively, the key to nonprofit status is that "[n]et earnings, if any, must be retained and devoted in their entirety to financing further production of the services that the organization was formed to provide."³⁶ Hansmann refers to this essential feature of nonprofits as the "nondistribution constraint."³⁷

To simplify explanation and analysis, Hansmann next offers a taxonomy of nonprofits in terms of two factors: how they are financed and by whom they are controlled.³⁸ With respect to financing, he identifies two polar modes, donative and commercial.³⁹ Donative nonprofits receive most of their revenues from grants or gifts; commercial nonprofits depend on the prices they charge for the goods and services they provide.⁴⁰ Those from whom the revenues come, whether in the form of gifts or purchases, Hansmann calls "patrons."⁴¹ With respect to control, the second factor in Hansmann's taxonomy, the critical question is whether it lies in the hands

BELL J. ECON. 531 (1983). My discussion follows Hansmann's account for several reasons: his is among the earliest and is probably the fullest to date, his is written in non-technical language intelligible to lawyers not trained as economists, and his is the basis for his own detailed normative discussion of tax policy.

³⁴ Hansmann, *supra* note 17, at 838.

³⁵ *Id.*

³⁶ *Id.* Though this dual definition of nonprofit status in terms of first, the prohibition of distribution of profits to controllers, and second, the requirement that profits be used to further the organization's purpose, is technically correct, its succinct statement elides an important point: in the case of many mutual commercial nonprofits, the organization's purpose is to confer benefits on its members, who are also its controllers. See *infra* notes 163-79 and accompanying text for a discussion of mutual commercial nonprofits operated for the benefit of patrons.

³⁷ Hansmann, *supra* note 17, at 838.

³⁸ *Id.* at 840-42.

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Id.* at 841.

of patrons or others.⁴² In mutual nonprofits, patrons control; in entrepreneurial nonprofits, others control.⁴³ Combining these two factors, means of financing and locus of control, Hansmann generates a four-part division of the nonprofit sector into donative mutuals, donative entrepreneurial, commercial mutuals, and commercial entrepreneurial.⁴⁴ He is careful to note, however, that these four categories are ideal types; particular organizations will exhibit varying mixes of financial sources and degrees of patron control.⁴⁵

Having marked off his territory and defined his terms, Hansmann turns to his account of the economic role of nonprofits. He first describes the normal⁴⁶ provision of goods and services in a market economy:⁴⁷

Economic theory tells us that, when certain conditions are satisfied, profit-seeking firms will supply goods and services at the quantity and price that represent maximum social efficiency. Among the most important of these conditions is that consumers can, without undue cost or effort, (a) make a reasonably accurate comparison of the products and prices of different firms before any purchase is made, (b) reach a clear agreement with the chosen firm concerning the goods or services that the firm is to provide and the price to be paid, and (c) determine subsequently whether the firm complied with the resulting agreement and obtain redress if it did not.⁴⁸

Hansmann suggests that "nonprofit enterprise is a reasonable response to a particular kind of 'market failure,' specifically the in-

⁴² *Id.* at 841-42.

⁴³ *Id.*

⁴⁴ *Id.* at 842. As examples of the first, he lists Common Cause, the National Audubon Society, and political clubs; of the second, CARE, the March of Dimes, and art museums; of the third, the American Automobile Association and country clubs; and of the fourth, the National Geographic Society, the Educational Testing Service, community hospitals, and nursing homes. *Id.* (diagram).

⁴⁵ *Id.* at 841-42.

⁴⁶ I use "normal" here with purposeful ambiguity. As we shall see, orthodox theory takes the market economy as the "norm" in two senses. The first sense is descriptive; market provision of goods and services is what happens most of the time in capitalist economies. The second sense, by contrast, is more strictly normative; market provision is presumptively "as it should be" or "best." At this point in his analysis, Hansmann is taking market provision as the norm in the first, descriptive sense. When he turns to the tax exemption of nonprofits, however, he tends to treat the market as the norm in the second, evaluative sense, without clearly identifying the difference or the reason for the shift. See *infra* notes 285-90 and accompanying text for a discussion of Hansmann's analysis.

⁴⁷ Hansmann, *supra* note 17, at 843-45.

⁴⁸ *Id.* at 843 (footnote omitted).

ability to police producers by ordinary contractual devices." His generic term for this problem is "contract failure."⁴⁹

Hansmann identifies three basic forms of contract failure.⁵⁰ The first, which he calls "separation between the purchaser and the recipient of the service,"⁵¹ is symptomatic of donative nonprofits. This situation prevails, in Hansmann's view, with respect to "the most traditional of charities — namely those that provide relief for the needy."⁵² Take, for example, the case of the typical donor of CARE, who is in effect "financ[ing] a relatively simple service, namely shipping and distributing foodstuffs and other supplies to needy individuals overseas."⁵³ The problem, as Hansmann sees it, is that:

If CARE were organized for profit, it would have a strong incentive to skimp on the services it promises, or even to neglect to perform them entirely, and, instead, to divert most or all of its revenues directly to its owners. After all, few of its customers could ever be expected to travel to India or Africa to see if the food they paid for was in fact ever delivered, much less delivered as, when, and where specified.⁵⁴

⁴⁹ *Id.* at 845.

⁵⁰ Hansmann does not treat these three kinds of contract failure as exhaustive; indeed, he identifies two others, voluntary price discrimination, *id.* at 854–59, and implicit loans, *id.* at 859–62. He uses the former to explain patrons' contributions to performing arts organizations and the latter to explain alumni donations to colleges and universities.

Hansmann has been criticized on the grounds that these two other forms of contract failure tend to diminish rather than enhance the contract failure theory's explanatory power. See J. DOUGLAS, *supra* note 9, at 98 ("Hansmann decorates this basic theme with subsidiary arguments that are often insightful but occasionally over-ingenious."). Voluntary price discrimination, however, is a particular instance of the public goods problem. Implicit loans, on the other hand, do seem to lack the common characteristic of contract failure, an information asymmetry that suppliers may exploit to the disadvantage of their patrons. See *infra* notes 107–20 and accompanying text for a discussion of both voluntary price discrimination and implicit loans.

⁵¹ Hansmann, *supra* note 17, at 846.

⁵² *Id.*

⁵³ *Id.* (footnote omitted).

⁵⁴ *Id.* at 847. This is only a problem, of course, if donors are interested not just in making themselves feel virtuous, but also in feeding the hungry. Gordon Tullock points out that if donors' concerns are restricted to the former, they lack any incentive to monitor delivery of goods. Tullock, *Information Without Profit*, in *PAPERS ON NON-MARKET DECISION MAKING* 141, 142–44 (Thomas Jefferson Center for Political Economy (1966)). We may assume, with Hansmann, that at least some significant subset of famine relief donors are interested not only in feeling virtuous, but also in doing good. See R. WOLFF, *THE POVERTY OF LIBERALISM* 178–80 (1968) (answering the argument that "[a]ny desire or interest, the definition of whose object includes reference to actual states of affairs, can be perfectly adequately satisfied by an object in whose definition are substituted references to the subject's *beliefs* about those

In the face of this inability to monitor the performance of a for-profit, the donor is likely to turn to a nonprofit, which is legally forbidden to pay out any of its receipts as "profits" and is thus less likely to skimp on the promised service.⁵⁵

The second form of contract failure occurs in the case of what economists call "public goods,"⁵⁶ goods with two distinct character-

states of affairs" (emphasis in original)). Moreover, Tullock acknowledges that appearance and reality are not entirely unrelated. Even donors interested primarily in purchasing personal satisfaction are likely to suffer the disutility of embarrassment in discovering that their chosen donee organization is fraudulent, as opposed to merely wasteful. Tullock, *supra*, at 144.

⁵⁵ Hansmann, *supra* note 17, at 847. Something analogous may occur when the payor is the government. The government may find it advantageous to subsidize a large variety of goods like health care, housing, and education through the exemption subsidy rather than to provide them directly. The ultimate recipients of this largess are likely to be relatively numerous, dispersed, disparate, and hence difficult to contact for purposes of directly monitoring output. Moreover, the outputs themselves are likely to be highly varied, requiring multiple kinds of expertise if monitored directly. The government, therefore, may find it cost-effective to do its policing indirectly, through the imposition and enforcement of nonprofit status. Here the contract would be with the providers themselves, probably a smaller group than the recipients, and the form of monitoring would be more standardized, auditing for fairly familiar forms of self-dealing and similar abuses of nonprofit status.

Estelle James offers a less generalized—or more cautious—form of this monitoring-cost reduction theory of governments' preference for nonprofits:

[I]n some industries such as education that are characterized by many small enterprises, providing services rather than countable objects, monitoring each one by the government would be very costly. The one-way term *subsidy* or *grant* rather than the reciprocal term *purchase* suggests the difficulty in measuring quid pro quo. Nonprofit status assures the government that its subsidy will indeed be used to increase inputs providing some of the services in question, not simply distributed as profits.

James, *The Nonprofit Sector in Comparative Perspective*, in *THE NONPROFIT SECTOR*, *supra* note 2, at 397, 408 (emphasis in original). As James notes, this is not to deny that fears of for-profit abuse enter into the preference for nonprofit firms. The point is that "[t]hey enter . . . not because of the attitude of many small donors but, rather, because of one large donor with the power to set certain basic contractual terms—the government." *Id.* (footnote omitted). Moreover, James's research suggests that this is true not only of the United States government, but of others as well, in both developing and industrialized nations. *Id.* at 398.

Hansmann himself offers such an explanation of the requirement of nonprofit status for tax exemption and other governmental benefits:

[O]ne important reason that statutes providing subsidies and special preferences require that the recipient organizations be nonprofit is presumably that these statutes are providing donations of a sort to these organizations, and seek the fiduciary restraints of the nonprofit form for the same reasons of contract failure as do other donors.

H. Hansmann, What is the Appropriate Structure for Nonprofit Corporation Law? 22 (Yale University Institute for Social and Policy Studies Program on Nonprofit Organizations Working Paper No. 100, Sept. 1985).

⁵⁶ Hansmann, *supra* note 17, at 848–54.

istics. First, the good is no more costly to provide to many than to one, because each can enjoy the good simultaneously without interfering with the others' enjoyment. Second, once the good has been supplied to one, it is not feasible to exclude others from enjoying it as well. Thus, in the case of radio broadcasts, it is no more costly to send transmissions to everyone in a given area than to a single person, and it is difficult to ensure that only those who pay for the broadcast will receive it. These conditions lead to an underproduction of public goods by private firms, even though demand for them may be high.

Radio stations avert the "free-rider" problem by relying on advertisers rather than listeners for their financing.⁵⁷ Some people, however, are willing to pay for advertisement-free radio and other public goods. But if they try to buy them from for-profit firms, they will not be readily able to ensure that what they pay goes for greater output, rather than for higher profits at the same level of output. Thus, they are inclined to "buy" from a nonprofit, which is forbidden to pay out any "profits." Listener-sponsored radio stations are for this reason invariably nonprofit, and, more generally, nonprofits tend to dominate the non-governmental provision of public goods.⁵⁸

The third form of contract failure occurs in connection with what Hansmann calls "complex personal services."⁵⁹ Some services — health care and education are Hansmann's examples — may be so complex that the purchaser will be unable to monitor quality effectively at a reasonable cost, even though the service is being supplied directly to the purchaser. In particular, purchasers may worry that the marginal dollar they spend for the service is not being used to improve the quality of the service, but rather to increase distributable profits. Here again, Hansmann maintains, this risk is lessened in the case of nonprofits, where such distributions are forbidden.⁶⁰

⁵⁷ *Id.* at 848–50.

⁵⁸ *Id.* at 850–51.

⁵⁹ *Id.* at 862–72.

⁶⁰ *Id.* at 862–63. Krashinsky notes that nonprofit production is only one of several alternative ways of dealing with consumers' difficulty in monitoring quality of output. One is professionalism; another is governmental regulation. And Krashinsky identifies several institutions in the market itself that function to relieve consumer uncertainty about quality: "[w]arranties, liability laws, insurance against liability (with the accompanying role of insurance companies to minimize risk), reputation, franchising, department stores (which can serve as middlemen for consumers) and so on." Krashinsky, *Transaction Costs and a Theory of the Nonprofit Organization*, in *THE ECONOMICS OF NONPROFIT INSTITUTIONS*, *supra* note 33, at

Thus, in each of the three forms of contract failure he identifies, Hansmann maintains that the nonprofit form, with the nondistribution constraint as its essential characteristic, gives consumers the assurance that their difficulty in evaluating output will not be exploited to enhance distributable profits. To draw from this the further conclusion that in such cases nonprofits are the most efficient suppliers, however, requires two further premises. Both of them are questionable, and Hansmann makes only one of them clear.

The clearer premise is that possible inefficiencies inherent in the nonprofit form do not offset the efficiency advantage of the nondistribution constraint in preventing skimming. Ironically, the problem is traceable to the nondistribution constraint itself, which precludes control of nonprofit organizations by those who are entitled to share in their net revenues. Elimination of equity owners may be a mixed blessing. Removing control by anyone with a personal pecuniary interest in the bottom line also removes a potentially important cost-control mechanism. Without equity owners looking over their accounts, if not their shoulders, nonprofit managers lose an important incentive to minimize costs.⁶¹ Hansmann's theory, if

114, 116-17. Hansmann too is aware of such alternatives, and he discusses the multiplicity of factors that influence when nonprofit production is likely to predominate. Hansmann, *supra* note 17, at 868-72; Hansmann, *supra* note 5, at 30.

Several empirical studies have been made of whether the complex goods form of contract failure does in fact account for consumers' patronage of commercial nonprofits. One concluded that the results of telephone inquiries sampling consumer recognition of, and attitudes toward, nonprofits suggest "some divergence from the Hansmann theory." Perlmutter, *Consumer Perceptions of Nonprofit Enterprise: A Comment on Hansmann*, 90 YALE L.J. 1623, 1626 (1981). Hansmann counters that, given his view that contract failure is less significant in commercial nonprofits than in donatives and the fact that the interviews did not select for patrons of nonprofits, the responses tend to confirm his hypothesis. Hansmann, *Consumer Perceptions of Nonprofit Enterprise: Reply*, 90 YALE L.J. 1633 (1981). Hansmann is similarly sanguine about two other studies, one on nursing homes, Weisbrod & Schlesinger, *Public, Private, Nonprofit Ownership and the Response to Asymmetric Information: The Case of Nursing Homes*, in *THE ECONOMICS OF NONPROFIT INSTITUTIONS*, *supra* note 33, at 133, and the other on child care, J. Newton, *Child Care Decision-Making Survey—Preliminary Report* (1980) (unpublished manuscript; Yale University Institute for Social and Policy Studies Program on Nonprofit Organizations). Hansmann, *supra* note 5, at 32-33.

⁶¹ See Hansmann, *supra* note 5, at 38; Hansmann, *supra* note 17, at 878. Nonprofit firms have evolved mechanisms to address this problem, see Fama & Jensen, *supra* note 33, and the empirical data on the degree to which nonprofit managers succumb to this problem is mixed. See Steinberg, *Nonprofit Organizations and the Market*, in *THE NONPROFIT SECTOR*, *supra* note 2, at 118, 127-30. For-profit firms themselves, of course, are not immune to problems in the separation of ownership and control. See A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932); Steinberg, *supra*, at 129. For a summary of recent theories on the departures of for-profit management from profit maximization, see Clarkson,

not explicitly sanguine on that score, assumes *arguendo* that nonprofit management will overcome the temptations of waste, or worse, at least to the extent that losses from waste attributable to lack of scrutiny by equity owners do not exceed gains from the reduced incentives to increase distributable income by skimming.

The less explicit premise also involves the policing of performance. Hansmann argues that the nondistribution constraint assures patrons of nonprofits that their payments will be used for their intended purpose, not diverted from increased production to above-market profits. The nondistribution constraint itself, however, is not self-policing. As Hansmann points out, it operates as a standardized contract enforced by the government.⁶² For this arrangement to be more efficient, the government's monitoring costs must be less than both individual patrons' monitoring costs in the transaction with for-profits and the individuals' efficiency gains in the nonprofit transaction. If either condition is not met, the use of nonprofits would represent not an efficiency gain, but merely an externalization of patrons' monitoring costs onto a third party, the government and, indirectly, the public.⁶³

Thus, it is important to remember that, though the superior efficiency of nonprofits in industries exhibiting contract failure is plausible, and perhaps probable, it rests on premises that are nonetheless unproven. For purposes of this paper, however, I, with Hansmann, will accept those premises. Their factual accuracy is entirely compatible with the reservations I raise below about the contract failure theory.

III. A RESPECTFUL HERESY — THE ROLE OF ALTRUISM IN NONPROFITS

Hansmann's model is a profoundly powerful analytic exercise. It tends, however, to overlook the role of altruism in nonprofits. This omission weakens the descriptive power of Hansmann's theory and leads him, as we shall see in section V, to restrict the scope of nonprofit tax exemption unduly. In this section, we shall examine the role of altruism in nonprofits by adding to Hansmann's two-variable descriptive framework a third factor, the locus of the ben-

Managerial Behavior in Nonproprietary Organizations, in *ECONOMICS OF NONPROPRIETARY ORGANIZATIONS*, *supra* note 33, at 4, 4-5.

⁶² Hansmann, *supra* note 17, at 853.

⁶³ See Ellman, *supra* note 33 at 1015 (suggesting that state enforcement of charitable trusts is often inadequate because states are unwilling to bear costs of monitoring).

efits that nonprofit organizations provide.⁶⁴ My approach is to consider the locus of benefits in each of Hansmann's four categories of nonprofits: donative entrepreneurial, donative mutual, commercial entrepreneurial, and commercial mutual. Combining this third factor with the mode of finance and the locus of control reveals that there are ten different species of nonprofits, which fall into two broad genera, altruistic organizations and mutual benefit organizations.⁶⁵

A. Donative Entrepreneurials — The Easy Case for Altruism

Donative entrepreneurial nonprofits provide the most intuitively clear illustrations of the role of altruism. Accordingly, in discussing these organizations I try to distinguish a kind of altruism that will be less readily apparent in other species of nonprofits, a kind of altruism that Hansmann's contract failure account systematically ignores.

⁶⁴ I am hardly the first to note the importance of altruism in the nonprofit sector. Altruism has frequently been cited as a central aspect of one kind of nonprofit, the charitable organization. Ellman, *supra* note 33, at 1021 n.51 ("It has also been said that the core feature of charity is that it is not 'self-regarding,' but 'other-regarding.'"); Sacks, *supra* note 28, at 519-20 ("To some . . . philanthropy is a working reflection of altruism, of 'love of mankind,' and therefore intrinsically inconsistent with private profit."). But prior accounts seldom emphasize the altruistic aspect of commercial, as opposed to donative, nonprofits. This is also true of a forthcoming study, HALL & COLOMBO, *THE CHARITABLE STATUS OF NONPROFIT HOSPITALS: TOWARD A DONATIVE THEORY OF TAX EXEMPTION*. Furthermore, systematic discussions of the role of altruism in nonprofits have tended to focus on a subjective selflessness that is hard to identify in particular cases and thus of limited utility as a criterion for government policies toward nonprofits, as I indicate *infra* at notes 94-113 and accompanying text. By contrast, I examine the entire spectrum of nonprofit organizations in an effort to identify a more practicable definition of altruism.

⁶⁵ My ten-part taxonomy and its derivation from the three relevant factors are set out graphically in an appendix. Without undertaking a detailed defense of the much-maligned significance of classification, I take immodest comfort in the recent words of a fellow taxonomist:

Nature is full of facts, but any "album" for their arrangement must record human decisions about order and cause. Thus, taxonomies represent the height of human creativity, and embody our most fundamental ideas about the causes of natural order.

Gould, *Judging the Perils of Official Hostility to Scientific Error*, N.Y. Times, July 30, 1989, at E6. In the social, and sometimes even in the natural, sciences, see S. GOULD, *THE MISMEASURE OF MAN* (1981), classification schemes may reflect not only ideas of cause, but also matters of policy preference. Thus, my taxonomy of nonprofits in terms of altruism is the prelude to my policy analysis of the nonprofit tax exemption in section V, where I examine the possibility of grounding part of that exemption on the altruism that I identify in this part as an essential characteristic of certain classes of nonprofit organizations.

1. Type 1 Organizations — Donative Nonprofits Operated for the Benefit of Neither Donors nor Controllers

To see more concretely what Hansmann's theory omits, we need to examine his conflation of donations and purchases, a revealing peculiarity in the way he explains nonprofits as a solution to contract failure itself. This peculiarity is most apparent in Hansmann's discussion of relief organizations like CARE, a donative entrepreneurial that is his prototypical case of contract failure.⁶⁶

Somewhat counterintuitively, Hansmann speaks of those who finance CARE's overseas relief operations as "purchasers," rather than, as ordinary usage would suggest, as "contributors" or "donors."⁶⁷ Hansmann's choice of terms is not accidental. As he says in discussing another relief organization, the Red Cross:

[T]he contributor is in effect buying disaster relief. And the Red Cross is, in a sense, in the business of producing and selling that disaster relief. The transaction differs from an ordinary sale of goods or services, in essence, only in that the individual who purchases the goods and services involved is different from the individuals to whom they are delivered.⁶⁸

This difference, I would suggest, may ultimately be more significant than any similarity; it is the essence of altruism.

Hansmann explains what he rightly calls "redistributive philanthropies" without reference to the problem that their donors are evidently trying to address, i.e., what they perceive as inequities in the distribution of goods and services. These inequities are not a "market failure" of the kind identified by the descriptive mode of neo-classical economics, which takes the existing distribution of resources as a given.⁶⁹ It can plausibly be characterized that way, as

⁶⁶ Hansmann, *supra* note 17, at 846-47.

⁶⁷ *Id.* at 847, 872-73.

⁶⁸ Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54, 61 (1981); see also Hansmann, *supra* note 17, at 872-73.

⁶⁹ It is, I should point out, possible to treat "maldistribution" as a problem within traditional economic theory, very much along the lines Hansmann takes in his particular examples. See Hochman & Rodgers, *Pareto Optimal Redistribution*, 59 AM. ECON. REV. 542 (1969) for an effort to describe an optimal level of redistribution on the assumption that the utility functions of the wealthy are interdependent with those of the poor, i.e., that the wealthy feel themselves better off as the well-being of the poor increases. Under this theory, those who are willing and able to redistribute their own wealth to others have, by definition, a "demand" for redistribution, though there may be an undersupply, owing to the "free rider" phenomenon.

A peculiarity of this approach, though not a technical flaw, is that, by definition, it

Hansmann shows, but only at the cost of obscuring another problem. The problem in the minds of the donors is the existing distribution of resources. They see a need for "relief services" on the part of those whose very destitution means that they can have no demand of the kind cognizable by neo-classical economic analysis, that is, the ability as well as the willingness to pay for the product in question.⁷⁰ From this perspective, the market failure identified by Hansmann is derivative. It arises only when donors try to find a means of alleviating what they perceive as a very different problem, not a failure of the market to allocate resources efficiently, but a fundamental flaw in the original distribution of resources that economists typically take as a given.

Another way to make this point is to turn Hansmann's CARE example around, putting CARE's donors on the supply side and its

excludes direct reference to the preferences of the poor, because they are not registered in ability to pay. See Gergen, *The Case for a Charitable Contributions Deduction*, 74 VA. L. REV. 1393, 1397-98, 1414 (1988) (citing this peculiarity as a reason for testing the desirability of public subsidization of disaster and poverty relief on the basis of Kaldor-Hicks efficiency rather than Pareto optimality, because the former allows benefits to the needy to offset costs to the unwilling wealthy). Hochman and Rodgers themselves concede that "[o]f course, one might personally feel the amount of redistribution dictated by the Pareto criterion will not be 'enough,'" and they expressly decline to say that "society should necessarily follow only the Pareto rule." Hochman & Rodgers, *supra*, at 556. See also Sugden, *On the Economics of Philanthropy*, 92 ECON. J. 341 (1982) (questioning empirical assumptions of Hochman and Rodgers's model).

For our purposes, the critical point is that the analysis of voluntary redistribution as a personal preference of the redistributors does not change the fact that it is a distinctive kind of preference, a preference that makes others materially better off at the expense of the redistributor. See *infra* notes 79-91 and accompanying text for a discussion of the significance of the fact that the redistributor may feel subjectively better off.

⁷⁰ This distinction is put nowhere better than in the introductory chapter of R. POSNER, *ECONOMIC ANALYSIS OF LAW* (3d ed. 1986). In describing the economist's concept of value, Posner gives an example that, coming from anyone else, would seem a strawman:

Suppose that pituitary extract is in very scarce supply relative to demand and is therefore very expensive. A poor family has a child who will be a dwarf if he does not get some of the extract, but the family cannot afford the price A rich family has a child who will grow to normal height, but the extract will add a few inches more, and his parents decide to buy it for him. In the sense of value used in this book, the pituitary extract is more valuable to the rich than to the poor family, because value is measured by willingness to pay; but the extract would confer greater happiness in the hands of the poor family than in the hands of the rich one.

Id. at 11-12. Purchase by the wealthy family, however, is more efficient. Posner uses the example to illustrate the limitations of economic efficiency as an ethical criterion, though he insists that the limitations are "perhaps not serious ones, as such examples are very rare." *Id.* at 12. Those who donate to CARE might dispute the rarity of such examples. "Surplus" grain, for example, can fill government silos or the bellies of beef cattle in America, or it can be put to arguably more pressing purposes here or overseas—"more pressing," of course, in terms of some mode of analysis other than neoclassical economics.

beneficiaries on the demand side. Economists' technical definition of demand inverts the common sense assessment of the transaction. That assessment makes CARE the vehicle by which its donors provide essential goods and services to those who need them but who cannot afford to pay for them. According to this view, the demand side is occupied by those who receive the organization's goods and services, though allocation is made on the basis of something other than ability to pay. Viewed from this perspective, CARE's donors are on the supply side, providing CARE with the factors of production necessary to produce its output, relief services. This is clearest when the donation is in kind rather than in cash, as when volunteers provide free labor. The donor is simply providing at no cost a factor of production that CARE would otherwise have to purchase. As Hansmann points out, CARE's basic inventory is provided in this way through the United States Government's Food for Peace program.⁷¹ But donors are no less on the supply side when their contribution is in cash; in that case, CARE simply receives the most fungible of assets, money, and uses it to purchase other inputs into the process of providing relief.⁷²

This re-characterization is not intended to suggest that Hansmann's demand-side account is inaccurate as far as it goes, or that Hansmann's approach does not make a useful analytic point. Rather, it is meant to show what Hansmann's approach omits, the distinctiveness of transactions in which one party confers a benefit on another without the expectation of a material reward.

"Redistributive philanthropies" like CARE and the Red Cross are the most obvious, but by no means the only, kinds of donative nonprofits through which donors may try to correct what they perceive as a problem in the market's provision of goods or services to others. Redistributive philanthropies are in an important sense the most general form of altruistic organization. But for an element of parentalism,⁷³ one would expect an altruist to give money and let donees buy what they think they most need.⁷⁴ Such altruism

⁷¹ Hansmann, *supra* note 17, at 846 n.39.

⁷² As we shall see, *infra* notes 189-93 and accompanying text, donors' contributions are sometimes better characterized not as providing particular variable inputs into the productive process for free, but rather as investments of return-free capital.

⁷³ I say "parentalism" rather than "paternalism" in part to avoid the latter term's connotations of officious intermeddling, but primarily to use a gender-neutral synonym. At least in my own experience, concern for another's welfare combined with a claim of superior insight into the other's needs can come from a parent of either sex.

⁷⁴ David D. Friedman makes this point, albeit with the traditional term. D. FRIEDMAN, PRICE THEORY 494-95 (1986). Friedman also suggests a second, related reason for not making

would be truly and exclusively redistributionist. Even CARE and the Red Cross are not purely redistributionist in this sense. They provide relief largely in kind, though under circumstances when there can be little doubt that the recipients would use monetary payments to buy precisely the same kinds of basic goods and services, if they were available. Many forms of philanthropy, on the other hand, involve an essential element of parentalism, which takes one of two basic forms.

The first form of altruistic parentalism seeks to encourage greater consumption of a particular good or service. Altruists of this ilk are of the view that at the prevailing market price (assuming there is one), others are consuming too little of something—say, health care or education—for their own good.⁷⁵ Altruists so persuaded would want to raise the level of consumption in either of two ways. On the one hand, they might attempt to increase the quantity of a good or service demanded by lowering its cost. Thus, those interested in promoting education might contribute to the college of their choice in order to defray the cost of education and presumably lower its price to the consumer. Or they might contribute to a scholarship program to subsidize individual students' purchases of education at the institutions of their choice. Similarly, if such altruists thought their fellow-folk were reading too few books, they might contribute to public libraries.

On the other hand, they might attempt to increase demand, perhaps by advertising. In this case the perceived problem would not be that others do not have sufficient resources to buy at the market price the goods the altruist thinks desirable, but rather that they do not appreciate how important those goods are. Religious observation is, in monetary terms at least, essentially free, but in the minds of many it is woefully underconsumed. In economists' terms, parentalists would seek to increase quantity demanded by increasing consumers' demand. To accomplish this, they might, for

outright transfers of money. The transferor may not be concerned primarily with the transferee's welfare, as perceived by either the transferee or the transferor. Instead, the transferor may be concerned about the effect on others, including the transferor, of changing the level of a transferee's consumption of a particular good. Thus, for example, a wealthy donor of scholarships may be less concerned about the education of particular students than about promoting a more educated society or attracting a better caliber of students to the transferor's alma mater. Similarly, Friedman points out, the fact that the federal food stamp program is not a cash transfer program may have less to do with feeding the poor than with promoting consumption of agricultural products. *Id.*

⁷⁵ Or for the good of still others. See D. FRIEDMAN, *supra* note 74, at 494-95.

example, contribute to organizations that erect billboards urging motorists to "Attend the church or synagogue of your choice."

Should altruists' fellow-folk heed these messages and attend a service, they might hear of another problem that altruists seek to correct: overconsumption, the concern of the second broad category of parentalistic altruism. Overconsumption is a common theme of sermons on several of the Seven Deadly Sins. Altruists' coins in the collection plate may subsidize efforts to decrease demand for, among other things: smoking, drinking, illegal drugs, pornography, and commercial sex. Coins in the coffers of the American Cancer Society and Mothers Against Drunk Drivers presumably advance efforts at reducing vices and their more secular ill effects. Such efforts frequently involve a classic public good that economists would expect the market to undersupply — publicly disseminated information about the health and safety (not to mention spiritual) hazards of substance abuse.⁷⁶

In all donative entrepreneurial nonprofits like those in the above examples, contributors do not receive adequate compensation in money or money's worth, and the net receipts benefit some class other than those who donate and those who control the donee organization. But to recognize the altruism inherent in the way that redistributive and parentalistic nonprofits address the perceived problems of maldistribution and over- or under-consumption is not to deny that there are sound and orthodox economic descriptions of how those problems arise. Donations to subsidize or discourage consumption can be described as a means of addressing problems of external benefits and costs, respectively. Beyond that, even redistribution of wealth can be viewed as a public good for which those with the wherewithal to indulge may have a demand cognizable under neo-classic economic analysis.⁷⁷ But no matter how helpful the economic account of these problems may be, the contract failure theory of nonprofits nevertheless overlooks the role of altruism in the donative nonprofit organization's form of solution.

⁷⁶ See *infra* notes 98–100 and accompanying text for a fuller discussion of the role of altruism in nonprofits' provision of public goods. Note the implicit assumption here that supporters of public awareness ads, such as those produced by the American Cancer Society and Mothers Against Drunk Driving (MADD), do not think of themselves as being in need of, or as benefitting directly from, the ads for which they pay. Instead, they buy them for the benefit of others. See *infra* notes 98–100 and accompanying text for a general discussion of other donative organizations that provide public goods. In this latter discussion, I remove the other-regarding assumption.

⁷⁷ See *supra* note 69 for a discussion of the idea that those with the ability to redistribute wealth may have a "demand" for such redistribution.

This emphasis on the altruism of donative nonprofits is not at odds with contemporary economic analysis of altruism itself as a self-regarding preference.⁷⁸ The altruism I have identified need not be subjectively pure. The donors I have described may be motivated wholly or in part by a desire for fame, a good name, divine favor (now or hereafter), or some other "selfish" concern. In this sense, I have identified a "weak" form of altruism. What is distinct about my donors is not that they give without gain, but that any satisfaction they derive from giving is not in the form of a material *quid pro quo* for their donation.

Other critics of the contract failure theory deny that altruism may sensibly be seen as self-regarding, insisting instead on a "strong" form of altruism. Indeed, one of those critics, James Douglas, argues that economists' denial of this "strong," or selfless, form of altruism is a major flaw in the market-failure account of charities.⁷⁹ I agree that altruism is what the economic account critically omits, but I find Douglas's account of "strong" altruism unpersuasive.

Douglas readily admits the explanatory power of economics, with its focus on self-regarding preferences. He insists, however, that some human motivation is wholly selfless, based on the following argument:

Any of us seeing a child drowning will rush to try and rescue him or her, certainly at the risk of getting our clothes wet and quite probably, in many cases, at the risk of our own lives. We may be under no legal obligation to do so. We are not seeking our own welfare. On the contrary, we almost certainly incur some slight economic risk and possibly a very large one.⁸⁰

Douglas is aware that the matter is subject to further analysis:

One can argue that the fact that we choose to save the child's life proves that we prefer the moral gratification it gives us to the cost of sending our clothes to the dry

⁷⁸ Gary S. Becker, for example, treats altruists as people whose demand schedules are peculiarly interdependent with those of others. When the latter enjoy what altruists give them, altruists are themselves happier than had they kept the gift. G. BECKER, *THE ECONOMIC APPROACH TO HUMAN BEHAVIOR* 282-309 (1976); see also D. FRIEDMAN, *supra* note 74, at 489-96.

⁷⁹ J. DOUGLAS, *supra* note 9, at 63-67.

⁸⁰ *Id.* at 65. Gladstone ups the ante; he offers for the same point the example of "the fireman who returns repeatedly, beyond the call of duty, to rescue those trapped in a blazing building." F. GLADSTONE, *CHARITY, LAW AND SOCIAL JUSTICE* 31 (1982).

cleaners. The concept of a preference function *can* be extended to cover any observed preference, whether self-seeking or altruistic, but only at the cost of tautology. Economic actors will choose according to their preference function, and their preference function is defined as what they choose.⁸¹

Expressly to avoid this circularity, Douglas imports into his analysis of charity Amartya Sen's "strong" concept of altruism.⁸² According to Sen:

[W]e must distinguish between two separate concepts: (i) sympathy and (ii) commitment. The former corresponds to the case in which concern for others directly affects one's own welfare. If the knowledge of torture of others makes you sick, it is a case of sympathy; if it does not make you feel personally worse off, but you think it is wrong and you are ready to do something to stop it, it is a case of commitment It can be argued that behavior based on sympathy is in an important sense egoistic, for one is oneself pleased at others' pleasure and pained at others' pain, and the pursuit of one's own utility may thus be helped by sympathetic action. It is action based on commitment rather than sympathy which would be non-egoistic in this sense.⁸³

In short, commitment, Sen's brand of strong altruism, involves "altruistic choices that do not contribute to one's personal welfare and may actually run counter to it."⁸⁴

The first thing to note about the drowning child and torture examples is that they merely stipulate what an instance of strong altruism would involve, self-sacrifice on behalf of another. They hardly prove that any particular rescue actually involves such altruism. How can we ever know that what prompts the rescue of a drowning child is not the desire for social acclaim, even at the risk of death, or the desire for a conscience clear of having refused assistance, even if such a conscience must be purchased with one's life?⁸⁵ At least since the time of Kant, ethicists have realized the distinction between showing what a purely selfless act would be like

⁸¹ J. DOUGLAS, *supra* note 9, at 65-66.

⁸² *Id.* at 66.

⁸³ Sen, *Rational Fools: A Critique of the Behavioral Foundations of Economic Theory*, 6 PHIL. & PUB. AFF. 317, 326 (1970).

⁸⁴ J. DOUGLAS, *supra* note 9, at 64.

⁸⁵ See Gergen, *supra* note 69, at 1433 n.137.

and showing that there has ever been, or will ever be, such an act.⁸⁶ Sen is aware of the difficulty of the latter, but neither he nor Douglas has done more than the former.⁸⁷

⁸⁶ In Kant's classic formulation of the problem:

It is in fact absolutely impossible by experience to discern with complete certainty a single case in which the maxim of an action, however much it may conform to duty, rested solely on moral grounds and on the conception of one's duty. It sometimes happens that in the most searching self-examination we can find nothing except the moral ground of duty which could have been powerful enough to move us to this or that good action and to such great sacrifice. But from this we cannot by any means conclude with certainty that a secret impulse of self-love, falsely appearing as the idea of duty, was not actually the true determining cause of the will. For we like to flatter ourselves with a pretended nobler motive, while in fact even the strictest examination can never lead us entirely behind the secret incentives . . .

I. KANT, FOUNDATIONS OF THE METAPHYSICS OF MORALS 27 (L. Beck trans., R. Wolff ed. 1969). This skepticism about human motivation was not, of course, original with Kant. Millennia before, Jeremiah had lamented, "The heart is deceitful above all things, and desperately wicked: who can know it?" *Jeremiah* 17:9 (King James). And modern psychology and psychoanalysis have certainly lent credence to the doubters.

⁸⁷ As Sen notes, "[a] more difficult question arises when a person's choice happens to coincide with the maximization of his anticipated personal welfare, but that is not the *reason* for his choice." Sen, *supra* note 83, at 327 (emphasis in original). In such cases, he maintains, the choice is based on commitment if it "would be unaffected under at least one counterfactual condition in which the act chosen would cease to maximize personal welfare." *Id.* The problem, however, is to prove that such a counterfactual condition exists. Sen concedes that "[c]ommitment in this more inclusive sense may be difficult to ascertain not only in the context of others' choices but also in that of one's own, since it is not always clear what one would have done had the circumstances been different." *Id.* Nor does he go on to indicate how this alternative choice—even by one's self—would *ever* be clear.

Gergen recognizes at one point the dual motivation problem that bedevils Sen's supposedly selfless commitment: "[a]cting out of commitment may be characterized as satisfaction-seeking behavior, insofar as the act may be done to avoid feelings of guilt." Gergen, *supra* note 69, at 1433 n.137. Yet at another point Gergen seems to ignore the problem of self-deception that Kant and the prophet identify. He insists that "[i]n describing human behavior it is important not to ignore personal experience, for perhaps the deepest and richest understanding of human motivations can come from self-scrutiny." *Id.* at 1429. On that theory, he recommends "[a]sk[ing] yourself if you give to charity out of a reasoned judgment that the satisfaction of giving . . . matches that of other possible expenditures." *Id.* After examining his own family's charitable giving, he concludes that "[o]nly sometimes does the description of the act of giving as pleasurable in itself, or as performed in order to receive another source of satisfaction, ring true." *Id.* He finds that gifts to social welfare charities generally meet his standard of subjective purity. *Id.* at 1449.

But the higher motives he identifies are feelings of "obligation," "duty," "responsibility," and even "embarrassment" and "social pressure." *Id.* at 1429, 1449. As he himself points out in criticism of Sen, avoiding feelings of guilt—feelings that might well accompany breaches of perceived moral obligations—is itself satisfaction-seeking behavior. *Id.* at 1433 n.137. The avoidance of pain has always been an element of the hedonistic calculus, if sometimes less explicitly than the achievement of pleasure. J.S. MILL, UTILITARIANISM 10 (O. Piest ed. 1957).

Furthermore, to point out that cases like the drowning child example do not necessarily involve strong altruism is not tantamount to arguing in a circle. To ask whether a particular Samaritan's motives are at bottom selfish is simply to raise an empirical question. One only begs the question when one derives the answer from the premise that all actions are selfishly motivated. Nor is to ask the question about the Samaritan's motives to deny that it might be answerable, and answerable in the Samaritan's favor. It might be possible both to know the Samaritan's motives, and to know that they were pure. It may be true, as Lord Justice Bowen quipped, that the state of one's mind is as much a fact as the state of one's digestion.⁸⁸ And no doubt there are times when the law must require proof of the former.⁸⁹

It is hardly deniable, however, that the latter proof is in practice generally shorter and more certain. In the background of this section's descriptive account of nonprofits are the normative issues of section V, in particular, the reasons for according nonprofits favorable tax status. For that purpose, I need to identify a characteristic of some or all nonprofits that can be discerned by government agents, not just the organizations themselves, at reasonable cost in particular cases, as, for example, when an organization seeks tax exempt status. At that point, policy makers are likely to discover (to paraphrase the Prophet) that human institutions must be satisfied with examining outer appearances, leaving things of the heart to higher authorities. Thus, with an eye toward identifying a characteristic of nonprofits that can serve as an objective basis for their tax exemption, "weak" altruism seems the better candidate.⁹⁰ Whether it is itself an adequate candidate under other criteria will have to await the normative discussion in section V.⁹¹

For now, it is worth noting that a related concept is currently serving in a closely allied area of law. "Weak" altruism, or something very like it, is now one of the legal criteria of whether a gift is charitable under the common law of charitable trusts and under

⁸⁸ *Edgington v. Fitzmaurice*, 29 Ch. D. 459, 483 (1885).

⁸⁹ The fields of antidiscrimination and criminal law are obvious examples.

⁹⁰ See Bittker & Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299, 305 n.15 (1976) (for purposes of analyzing federal tax exemption, psychic returns to benefactors of public service organizations may safely be ignored).

⁹¹ One may well ask, for example, whether altruism is something deserving of preferred tax treatment, even if it can be identified. See *infra* notes 362-80 and accompanying text for a discussion of this point.

federal tax law. The donor cannot derive a reciprocal material benefit from the gift. Yet, as John Simon points out:

[P]rivate benefits that are not directly realizable in material terms (or contractually assured) do not count. . . . Nor does the fact that the donor's motives are less than selfless defeat the deduction; neither charitable trust law nor charitable tax law requires subjective altruism, despite the teaching of St. Paul: "And though I bestow all my goods to feed the poor . . . and have not charity, it profited me nothing."⁹²

The reason that subjective motives do not count is the practical problem to which I have already alluded: "[i]gnoring motive may be a necessity for the tax system; the search for purity of charitable

⁹² Simon, *supra* note 26, at 86 (citations omitted). The United States Supreme Court has recently held that a transfer without adequate consideration is a necessary but not sufficient condition of a charitable contribution under section 170 of the tax code when the donor receives some consideration in return for the transfer to charity. *United States v. American Bar Endowment*, 477 U.S. 105, 116-18 (1986) [hereinafter *ABE*]. In assessing whether any part of such "dual payments" qualifies as a charitable contribution, the Court adopted the Service's two-pronged test:

First, the payment is deductible only if and to the extent it exceeds the market value of the benefit received. Second, the excess payment must be "made with the intention of making a gift."

Id. at 117 (quoting Rev. Rul. 67-246, 1967-2 C.B. 104, 105 (so-called "bazaar ruling")).

Significantly, for our purposes, the inquiry into intent under the second prong of the test is not a search for the purely selfless motivation that characterizes Douglas's "strong" altruism. To meet the second prong of the *ABE* test, a taxpayer claiming to have made a deductible contribution need only show that she intentionally paid more than the market price of the good or service she received in return. *Id.* at 118; *see also* *Hernandez v. Commissioner*, 109 S. Ct. 2136, 2143-46 (1989) (re-affirming *ABE*'s emphasis on examining external features of putative donations, rather than subjective motivations, to determine deductibility under I.R.C. § 170). To apply the second prong more rigorously would run afoul of another line of cases, cited with approval by the Court in *ABE*, which permit charitable deductions for the full amount of a payment to charity when the donor receives nominal, though not necessarily merely psychic, benefits in return. *ABE*, 477 U.S. at 117.

In a related context, that of determining whether a transfer may be excluded from income as a gift under section 102 of the tax code, the United States Supreme Court has mandated a limited examination of motive. Under *Commissioner v. Duberstein*, 363 U.S. 278 (1960), excludable gifts must be motivated by "detached and disinterested generosity," which requires more than mere absence of common law consideration or legal obligation. *Id.* at 285-86. Here again, however, the additional showing is short of a requirement of "strong" altruism. Basically, the recipient must establish that the purported gift was not motivated by expectation of material gain or desire to reward past services. *See id.* at 291-92 (evidence supported finding that transfer to Duberstein was "at bottom a recompense for past services, or an inducement for him to be of further service in the future"). Nothing in the opinion suggests further inquiry into the selflessness of the transferor's motive.

intention would be an unmanageable task, even ignoring the complications caused by psychoanalytic theory."⁹³

To ignore subjective intent, of course, is to put considerable pressure on defining the forbidden reciprocal benefit, a concept that cannot be defined with complete precision. Some attenuated forms of personal benefit to the donor, even beyond the merely psychological, are — and may have to be — ignored.⁹⁴ Although it may be difficult to predict what degree or kind of private benefit will tip the scales in particular cases, it is nonetheless possible to identify the factors that weigh into the balance. It is, of course, equally possible to criticize the policy choices that lie behind even some of the clearer decisions.⁹⁵ The point to be made here is that,

⁹³ Simon, *supra* note 26, at 86. See also Hernandez, 109 S. Ct. at 2143, ("This practice [of focusing on the external aspects of a transaction] has the advantage of obviating the need for the IRS to conduct imprecise inquiries into the motivations of individual taxpayers."). A growing body of research, both theoretical and empirical, suggests that a significant motivation of donors might be the quasi-coercive push of social pressure. For brief accounts of this and other research on the motivations of donors, see Amos, *Empirical Analysis of Motivations Underlying Individual Contributions to Charity*, 10 ATLANTIC ECON. J. 45, 45-47 (1982); E. JAMES & S. ROSE-ACKERMAN, *supra* note 8, at 25-26.

⁹⁴ See Simon, *supra* note 26, at 86:

Deductions are not lost because the donor enjoys memorialization on the front of a building or at a testimonial dinner, enhanced college admission opportunities for the donor's child or business relations for the donor, hopes for salvation or at least the expectation of perpetual prayers, the shared benefits that come with public goods like parks or cleaner air, or the general expectation that somewhere, somehow, the giver will benefit.

⁹⁵ Mark Kelman, for example, insists that most large-scale givers enjoy some measure of reciprocal benefits from their donations, if only in the form of deference from donees, respect from peers, or increased self-esteem. Kelman, *Personal Deductions Revisited*, 31 STAN. L. REV. 831, 835 n.14, 844-49, 856-57 (1979). He also strongly implies that deductibility of charitable gifts under these circumstances is inappropriate. In part, he thinks the deduction inappropriate because it works against progressivity in the tax system. *Id.* at 880. But regressivity at one point in the tax system does not logically preclude progressivity of the whole, as I argue elsewhere, see *infra* text following note 324. There is, Kelman concedes, another reason for his opposition. As he succinctly puts it in his conclusion:

My opposition to the [income tax deduction for a] charitable donation is bolstered by my sense that charitable donors are the same as everyone else in an individualist culture: They use their money for their own relative benefit. Even the most sincere altruist buys the scarce resource of looking altruistic.

Id. at 880 (citation omitted). Cf. Gergen, *supra* note 69, at 1408 ("If by 'looking altruistic' he [Kelman] means being respected for acting charitably, one would guess that we are far from exhausting our capacity for respect.").

Even if charitable donors are like everyone else in some respects—even in the respect Kelman identifies—they are not necessarily the same in all respects. Kelman demonstrates as much by identifying the distinct kinds of benefits—deference, respect, access, and self-esteem—that charitable donors may receive under the present system without jeopardizing their tax deduction. The policy question that he ignores is whether the tax system should tolerate the receipt of such admittedly identifiable benefits as a possibly unavoidable cost of

despite unclarity at the margin, the central concept of weak altruism — a transfer without a quid pro quo — is not only intelligible, but also operable, as a criterion for drawing distinctions with important legal consequences.

For purposes of identifying a characteristic feature of nonprofit organizations, the concept of weak altruism needs another degree of refinement. Regard for others need not embrace the whole world. Rather, it spreads in concentric circles from immediate family to clan, tribe, class, and nation, perhaps to embrace all of humanity.⁹⁶ Moving outward along these expanding ripples of concern for others, one eventually crosses the frontier of charity. That frontier is defined somewhat differently in the lay and the legal parlance, but both are clear on the essential point. Though charity may begin at home, it is worthy of the name only after it has crossed the threshold.⁹⁷

In part, this insistence on a degree of Samaritanism, especially in the law, may be a crude proxy for both weak and strong altruism. Gifts close to home are likely either to meet legal obligations of the giver, as in the case of support of minor children, or to be motivated by expected reciprocity from the donee, as in the case of gifts within a close circle of friends. But in the more morally charged notions of charity, something else is clearly going on. A kind of activity is being singled out for approbation as inherently, not just instrumen-

encouraging philanthropy. Whether the charitable deduction is an effective or fair way to encourage philanthropy is an open, and much debated, question. See generally Simon, *supra* note 26, at 73-87; Brannon & Srinad, *Alternative Approaches to Encouraging Philanthropic Activities*, in 4 FILER COMMISSION PAPERS, *supra* note 3, at 2361. And, as we shall see, one can object to philanthropy itself, on practical grounds or as a matter of principle. See *infra* notes 366-79 and accompanying text for a more complete discussion of this point. None of that is to deny, however, that philanthropy is distinctive or that a desire to encourage it is an intelligible preference.

⁹⁶ Sen makes this point in emphasizing that utilitarianism, with its universalizing emphasis on the greatest good of the greatest number, is not the only alternative to egoism, even in terms of scope. Sen, *supra* note 83, at 318-19, 344. As he observes, "between the claims of oneself and the claims of all lie the claims of a variety of groups—for example, family, friends, local communities, peer groups, and economic and social classes." *Id.* at 318.

⁹⁷ See RESTATEMENT (SECOND) OF TRUSTS § 375 comment b (1957) (trust for benefit of relatives is not charitable). Just as the degree of permissible private benefit is difficult to define, so too is the requisite degree of remoteness, in part owing to the complexity of personal relationships. So, for example, the federal circuits have split on the issue of whether parents may deduct gifts for support of their children as Mormon missionaries. Compare *White v. United States*, 725 F.2d 1269 (10th Cir. 1984) (reversing denial of deduction and remanding) and *Brinley v. Commissioner*, 782 F.2d 1326 (5th Cir. 1986) (reversing denial of deduction and remanding) with *Davis v. United States*, 861 F.2d 558, 562 (9th Cir. 1988) (denying deduction "in a factual setting indistinguishable" from *White*).

tally, desirable. And this seems to underlie the legal preference for charity as well.

We need not linger over the distinctions between the lay and the legal definitions of charity or, for that matter, over the precise limits of either. At this point in our analysis, we need only remember that charity is a subpart of altruism. To avoid confusion with the legal concept of charity, which I shall take up again in section V, I shall use the term "altruistic" to describe organizations that confer benefits on persons other than their controllers or financiers. For the most part these organizations will also qualify, at least in a lay sense, as charitable, but I will use the broader term "altruistic" except where the difference is critical.

In all the examples discussed above, the beneficiaries were distinct from those who contributed to the organization, and both the donors and the beneficiaries were distinct from those who controlled the organization. Thus, in the case of CARE, the donors place their contributions in the hands of a second group, CARE's governing body, to be used to benefit a third group, overseas famine victims. These three groups—donors, controllers, and beneficiaries—need not, however, be separate in all donative entrepreneurial. The class of those who benefit from the organization could conceivably coincide with the class of either those who finance it or those who control it. Both these possibilities, donative entrepreneurial that are run for the benefit of their donors and donative entrepreneurial that are controlled by their beneficiaries, need to be examined. In each, the element of altruism is somewhat different from that in the donative entrepreneurial discussed above, and the difference sheds additional light on the role of altruism in nonprofit organizations.

2. Type 2 Organizations — Donative Entrepreneurials Operated For the Benefit of Donors

The combination of the donor and beneficiary classes seems at first impression to be inconsistent with the premise of donative financing. The paradox may be resolved in either of two ways. The first is through the public goods character of the benefits that donors expect to receive. If the benefit expected is a classic private good, the payment is not a donation but a purchase, and an organization supported by such payments is a commercial rather than an entrepreneurial nonprofit. As Hansmann and others have shown, however, quite often the goods produced by nonprofits are

public goods. Hansmann's listener-sponsored radio is a classic example; viewer-supported television is another. One can imagine such a broadcaster deriving its entire support from listeners who contribute no more than what they deem tuning in to be worth to them. Although no part of such a payment is intended to benefit others, it necessarily has a spillover effect. Those willing and able to pay for broadcasts unavoidably subsidize others who are unwilling or unable to tune in other than for free.⁹⁸

Here, then, is a transaction different both from ordinary purchases of private goods like automobiles and from contributions to redistributive nonprofits like CARE. Unlike the former, the "purchase" of public goods necessarily allows others to enjoy the same good in the same way; unlike the latter, it may well involve provision of a material good directly to the contributor. But because the donor could have enjoyed the good without paying anything to the provider, it does not seem odd to think of the payment as a donation rather than as a purchase.⁹⁹

Moreover, we have described the least intuitively altruistic kind of payment to a provider of public goods. Our initial assumption was that the donor gave no more for the broadcast she received than the broadcast was worth to her. It is quite conceivable that one might donate to the provider of a public good even though one does not consume the good; perhaps some people who do not own television sets nevertheless contribute to public television, on the theory that those who do watch should have a wider range of options.¹⁰⁰

The second resolution of the paradox of donor-benefitting donative entrepreneurialism lies not in the nature of the goods provided, but in the donors' relinquishment of control of the donation, and the consequent uncertainty that the donor will individually benefit from it. Consider a hypothetical hierarchical religious de-

⁹⁸ Indeed, Hansmann comes to much the same conclusion with respect to a prominent kind of patron-controlled nonprofit, trade association: "Since the services, such as political lobbying, that such organizations commonly provide are public goods, they can be enjoyed whether or not one belongs to or contributes to the organization, and thus contributions to such organizations have the character of donations." H. HANSMANN, *supra* note 55, at 36 n.65.

⁹⁹ It is, of course, possible to minimize this altruistic aspect. Gergen, for example, says that "[i]f altruism plays a part in giving to public television, it is only in suppressing the tendency to freeride." Gergen, *supra* note 69, at 1443.

¹⁰⁰ *But see id.* (suggesting that, by analogy to contributions to cultural organizations, donations to public television probably come primarily from viewers).

nomination. Congregations in this denomination are controlled by a priestess who is appointed by the church hierarchy and answerable only to it. Local congregations are, however, essentially self-help organizations. All funding for each parish comes exclusively from the members of the parish and is used solely for their benefit.¹⁰¹ Some of these benefits are likely to be public goods; preaching is an obvious example. But some are private goods, like individual spiritual counseling and material relief in the event of sickness or unemployment. If the individual member were assured of getting such counseling or disaster protection in proportion to his or her payment, one would be inclined to think that this transaction differed little from a purchase of psychotherapy services in the first example¹⁰² or an insurance policy in the second.¹⁰³ The difference

¹⁰¹ Available evidence suggests that this funding hypothesis is realistic. According to Gergen:

Churches are self-help charities: their supporters are also their primary beneficiaries. Churches obtain over four-fifths of their income from members, mostly in the form of relatively small contributions, and over four-fifths of church income goes to operations and current expenses Generally only a small percentage of church resources—at most ten to twenty percent—are devoted to nonsacramental functions, and some of these resources are devoted to services, such as day care or family counseling, that benefit parishioners.

Gergen, *supra* note 69, at 1434–35 (footnotes omitted).

¹⁰² This was essentially the view the United States Supreme Court took in denying charitable deductions to individuals who paid “auditing” and “training” fees to the Church of Scientology. *Hernandez v. Commissioner*, 109 S. Ct. 2136, 2143–46 (1989). In characterizing the stock-in-trade of religious organizations as “supernatural intangibles,” Veblen anticipated by six decades the donors’ best argument, the lack of a material quid pro quo. T. VEBLEN, *ABSENTEE OWNERSHIP AND BUSINESS ENTERPRISES IN RECENT TIMES* 323–24 (1923) (cited with evident amusement, if not approval, in Bittker & Rahdert, *supra* note 90, at 299, 343). The problem with this defense in the *Hernandez* case was that donors got individualized attention in the here and now that was scrupulously denied to non-contributors. *Hernandez*, 109 S. Ct. at 2143–46.

¹⁰³ See, e.g., *Bethel Conservative Mennonite Church v. Commissioner*, 80 T.C. 352, 359, *aff’d*, 746 F.2d 388 (7th Cir. 1984):

[P]etitioner established a medical aid plan for its members and their dependents only. The plan specifically provided that no membership fee was required so as not to exclude any of petitioner’s members from taking part in the plan. The plan was funded by voluntary offerings collected from members at worship services on the first Sunday of each month.

In affirming the Tax Court’s decision upholding the exemption status of the church despite the benefits to members under the plan, the Seventh Circuit noted that “the purpose of the program unquestionably is to provide an organized means for the Bethel Mennonite community to implement the longstanding Mennonite belief in the pooling of resources for its members’ benefit regardless of the members’ personal financial resources.” *Bethel Conservative Mennonite Church*, 746 F.2d 388, 391–92 (7th Cir. 1984) (emphasis added). Cf. Shaller, *Tax Exemption of Charitable Organizations and the Deductibility of Charitable Donations: Dangerous New*

in our hypothetical church is that the connection between donations and individual benefits is less certain. For one thing, individual benefits are in the priestesses' discretion. And even if they were automatic, they would depend on the level of others' contributions. Thus, even if all are entitled to relief when sick, overall contributions would limit the amount of relief the congregation could give.

The altruism of such self-help organizations is clearly a matter of degree. The more likely contributions are to be followed by a predictable quid pro quo, the lesser the degree of altruism. Moreover, in multifunction organizations like churches, the link between contribution and expected benefit will vary among different functions. A church's child care program may be supported almost entirely by tuition payments, whereas its relief work will probably be supported by those least likely to be in need. The former payments are hardly lacking in a quid pro quo;¹⁰⁴ the latter much more clearly so. Yet even in the latter, there is at least an arguable element of self-help. A common tenet in many religions, after all, is that there, but for the grace of God, go I. Though saints may find comfort in the belief that no sparrow falls by accident, we of lesser faith will be ever tempted to cover the down side by strengthening the safety net. And even if improving their own prospects is not the donors' motivation to give, it is certainly a foreseeable result. Yet at some point the prospect of reciprocity becomes thin. It could be argued, for example, that we are all members of humanity, and any gift that improves the lot of the race redounds to the donor's benefit, at least potentially.¹⁰⁵ That argument, of course, takes us back to an earlier point — some benefits to donors must simply be ignored as unimportant or overly remote¹⁰⁶ if the definition of weak altruism is to be workable. Here again, the heartland of the definition is clear, even if the borders present difficult cases.

Tests, 8 BRIDGEPORT L. REV. 77, 88 (1987) ("the church's medical plan, which was available only to members and their dependents, operated like other medical plans").

¹⁰⁴ Accordingly, the I.R.S. denies charitable contribution deductions for purported donations by a parent to a child's school in an amount suspiciously equivalent to tuition. See Rev. Rul. 83-104, 1983-2 C.B. 46 (particularly Situations 1 through 4).

¹⁰⁵ See, e.g., Douty, *Disasters and Charity: Some Aspects of Cooperative Economic Behavior*, 62 AM. ECON. REV. 580, 586 (1972) (analyzing disaster relief contributions as the price of a kind of informal mutual insurance).

¹⁰⁶ See Gergen, *supra* note 69, at 1431 n.131 (criticizing Douty's view of disaster relief contributions as involving too attenuated an element of reciprocity).

3. Type 3 Organizations — Donee-Controlled Donative Entrepreneurials

In Type 3 organizations, the role of altruism is clearer, as an example will show. Assume that our hypothetical hierarchical denomination decides to establish an overseas affiliate in an underdeveloped part of the country. Assume further that parishioners in the provinces are proud as well as poor. The parishioners' poverty means that their branch of the church must be wholly financed by the overseas parent. Clearly there is altruism in the contributions by members of the overseas parent church; they receive no material *quid pro quo*.

But the parishioners' pride means that they themselves insist on running the affairs of their own congregations with minimal interference from foreign priestesses. What effect does local control—donee control, in the example—have on the organization's altruism? The answer turns on how we define altruism. We can require only the donors' altruism, or we can insist on a measure of altruism in the donees as well. If we choose the latter, we would then look at whether control of the contributed goods is "socialized" and whether the benefits provided are public goods. It is important to note, however, that when we turn to the question of whether to require altruism on the donees' part, we move from description to prescription. Even without this extra measure of altruism, Type 3 organizations exhibit altruism in the fact that they are supported by donors who do not materially benefit by their operation.

B. *Donative Mutuals — Equally Clear Cases for Altruism*

Donative mutuals are controlled by their contributors; bear in mind that for our purposes "mutual" refers to the locus of control, not to the locus of benefit. The role of altruism in the two members of this category, Type 4 and Type 5, is essentially the same as in Type 1 and Type 2, respectively.

1. Type 4 Organizations — Donor Control for Others' Benefit

CARE could quite conceivably be controlled by its donors but still operate for the relief of the needy overseas. Similarly, a domestic religious organization might be funded and controlled exclusively by members whose donations are used only for overseas mission or relief work. In both cases, unlike comparable entrepreneurial donatives, those who control the organization are those who

finance it. But, like their entrepreneurial counterparts, these mutuals are operated for the benefit of others.

2. Type 5 Organizations — Donor Control for Their Own Benefit

As we saw in the case of Type 2 organizations, some donative entrepreneurial are operated for the benefit of their donors. The apparent problem of donors materially benefitting from their donations is resolved if the organization either provides public goods or provides private goods on a "socialized" basis. Recall that both of these elements were present in the hierarchically controlled church with congregations financed by members and operated for members' benefit. The same elements could also be present if such a church were organized on a congregational basis. In that case, the congregations would be examples of mutual donative nonprofits operated for the benefit of those who finance and control them.

C. *From Donative to Commercial Nonprofits — Altruism in Education and the Performing Arts*

Weak altruism seems completely compatible with Hansmann's general contract failure account of donative nonprofits. Significantly, however, Hansmann's account of two important kinds of donative nonprofits strongly implies that they lack any element of altruism. I shall present Hansmann's critiques first, then my response.

The first kind of donative nonprofits that lack altruism in Hansmann's account are performing arts organizations. According to Hansmann, performing arts are not a traditional "public" good, because "in general, the only people who derive any benefit from a performance are those who are in the audience."¹⁰⁷ He admits that "there is something to the argument that great cultural institutions confer prestige on the city, the region, or the country as a whole, and in this respect provide a public good." But he insists that "these remote public benefits seem quite small in proportion to the private benefits that a performance confers on its audience,"¹⁰⁸ and he concludes that "[s]urely these are not the most significant reasons for donations to the performing arts."¹⁰⁹ Furthermore, contribu-

¹⁰⁷ Hansmann, *supra* note 17, at 855.

¹⁰⁸ *Id.* at 855 n.62.

¹⁰⁹ *Id.*

tions to the performing arts, unlike gifts to CARE, do not for the most part benefit a needy class; "it seems unlikely that the primary reason that performing arts groups are nonprofit is to provide a vehicle for the rich to subsidize the upper middle class."¹¹⁰ Hansmann thus offers an alternative explanation:

In this situation contributions are, in essence, a form of voluntary price discrimination, or, in other words, a means whereby different customers can be charged different prices for the same service. . . . If everyone could be made to pay for a production roughly what it is worth to him, the total receipts for a production would be much higher than if the price is set at the amount that represents its worth to the member of the audience who values it least—which is the result with a single ticket price for everybody.¹¹¹

Hansmann argues that the nonprofit form of organization assures those who voluntarily pay more that the excess will be used to defray the high fixed costs of production, not to increase investors' profits.¹¹²

Higher educational organizations are the second kind of donative nonprofits in which Hansmann expressly questions the role of altruism. Hansmann notes that "[i]nstitutions of higher education commonly depend heavily on voluntary private contributions to cover their expenses."¹¹³ In explaining this, however, Hansmann again discounts the role of subsidizing others (in this case, needy students) and providing public goods like research. His theory is that alumni, the source of most contributions, are in fact paying back "implicit loans" that their alma maters made them at a time when, owing to failures in the private loan market, they could not borrow funds from other sources to finance their educations.¹¹⁴

¹¹⁰ *Id.* at 855.

¹¹¹ *Id.* at 856-57.

¹¹² *Id.* at 858. Hansmann has offered a formal model of "voluntary price discrimination." Hansmann, *Nonprofit Enterprise in the Performing Arts*, 12 BELL J. ECON. 341 (1981).

¹¹³ Hansmann, *supra* note 17, at 860.

¹¹⁴ *Id.* The question of whether repayments of these "implicit loans" are in fact truly donative transactions has important practical ramifications. Many educational organizations are now conditioning student aid on the recipient's undertaking a putatively nonbinding commitment to transfer a like amount to the institution at a later date. An important issue for both the organizations and the students is how extensive the latter's commitment under such "moral obligation loans" can be without jeopardizing the deductibility of subsequent "gifts" to the former under section 170 of the I.R.C. See Note, *Moral Obligation Financial Aid Programs*, 84 COLUM. L. REV. 1402 (1984).

Thus, in his accounts of performing arts organizations and higher educational organizations, Hansmann does not merely treat payments for the benefit of others as a self-regarding preference, as he does in explaining contributions to CARE. Rather, in explaining contributions to arts and educational organizations, he discounts altruism even in this "weak" form; contributors are not really subsidizing others, but are buying the organization's output for themselves through the only means available. But for voluntary price discrimination, New York's elite could not enjoy high-brow entertainment; but for "implicit loans," impecunious students could not finance their own private post-secondary education.

For several reasons, however, it would be wrong to conclude that nonprofits in either the performing arts or higher education are wholly lacking in altruism. This point is easiest to illustrate in the case of the performing arts. Assume that patrons pay no more through voluntary price discrimination than admission to nonprofit performances is worth to them personally.¹¹⁵ Even so, they are necessarily conferring a benefit on others, and a benefit that they need not confer in order to enjoy the same benefit for themselves. Hansmann acknowledges that, "for those individuals who pay the admission price for a given production, any increase in the quality of that production is a public good."¹¹⁶ This public good aspect of nonprofit performing arts presentations is, as Hansmann ably demonstrates, made possible by voluntary price discrimination, by some patrons' voluntarily paying more than the market price of tickets.¹¹⁷ This, then, is but a special case of the kind of altruistic provision of public goods that we saw above in connection with listener-sponsored radio.¹¹⁸

¹¹⁵ Of course, some patrons of the arts may contribute beyond the value to themselves of attending particular performances; a significant part of voluntary donations to performing arts organizations may in fact be subsidies by the rich of the nearly rich or soon-to-be rich, or efforts to provide "trickle-down" benefits to the public at large. I ignore this possibility in the text, however, to show that even without a conscious effort to benefit others, donations to performing arts organizations involve an element of altruism.

¹¹⁶ Hansmann, *supra* note 17, at 858.

¹¹⁷ *Id.* at 857-58.

¹¹⁸ See *id.* at 858 (noting that donors to performing arts organizations experience the same kind of contract failure problem as donors to listener-sponsored radio). The federal income tax treatment of donations to performing arts organizations also reflects its similarity to gifts to listener-sponsored radio and viewer-sponsored television. Only the amount paid that exceeds the fair market value of the ticket is treated as a charitable deduction. Rev. Rul. 67-246, 1967-2 C.B. 104, Examples 1 and 2. Similarly, with respect to contributions to public broadcasting, the amount of a payment to a nonprofit organization is only deductible to the extent it exceeds the value of "premiums"—teddy bears, T-shirts, and coffee mugs—received

With respect to higher education, the element of altruism on the donor's part is not quite so evident. A university degree, like the Grand Tour that once complemented it, is essentially a private good. Those who do not pay can readily be excluded, and providing the same level of benefits to additional individuals incurs substantial marginal costs. This is not to say, of course, that those who receive the education (or the tour) do not add something in the way of "spillover benefits" to the general cultural level of their society. But the primary benefits go to the recipients themselves, and the market can fairly readily set a price on those benefits. Those who pay for their own higher education, either up front or through an explicit or implicit loan, presumably get what they pay for.

Arguably, however, they may have gotten something more. They may have come to believe that opportunities for higher education should be made available on the basis of something other than ability to pay, and they may accordingly give to the college of their choice. Similarly, and somewhat more parentalistically, those who have had the benefit of, say, a liberal arts education may believe that one cannot fully appreciate the value of such an education until one has it. In their view, potential liberal arts students might be inclined to opt for what the students myopically perceive to be a more economically attractive alternative—employment in a fast-food franchise, for example. To make the choice of the liberal arts education marginally more attractive, alumni would subsidize it through contributions that defray part of the cost. These alumni may contribute to their alma maters not because they feel obliged to pay off implicit loans, but because that is where they got the kind of education they think others should have.

Whether donations to universities are in fact repayments of implicit loans is a fairly straightforward empirical question. Presumably at least some alumni contribute beyond any reasonable repayment of principle and interest, and many universities receive substantial gifts from donors who are not alumni. Whether such supererogatory gifts are purely motivated is of course a trickier question. Some donors no doubt glory in having their names attached, literally or otherwise, to ivied walls; others certainly seek to bask in the reflected glory of their alma mater's faculty and future

in return. See Rev. Rul. 67-246, Example 4. In both cases, the basic principle is the same—the gift portion of the transaction is that for which the donor receives no material quid pro quo.

alumni.¹¹⁹ Here again, however, it must be borne in mind that all I insist upon is "weak" altruism—in this case, payments for the benefit of third parties without adequate consideration in money or money's worth to the payor. For my purposes, and in the eyes of common law courts and the federal income tax authorities, reflected glory is a tolerable taint.

This still leaves the easy empirical question unanswered. What if, as Hansmann's hypothesis suggests, most putative donations to institutions of higher learning are in fact repayments of implicit loans? Even if the donors are in reality only purchasing private benefits on an installment plan, the fact remains that the institutions themselves are operating under the nondistribution constraint. In a sense, then, Hansmann's explanation of these organizations, if correct, shows them to be "commercial" nonprofits, nonprofits financed not by gifts but by the sale of goods and services consumed by the purchasers.¹²⁰ As we shall see in the next subsection, altruism—albeit in a somewhat different form—plays a significant role in commercial as well as donative nonprofits.

D. *Commercial Entrepreneurials—Is There Altruism Here Too?*

Altruism is not difficult to find in donative nonprofits. In fact, as the first part of this section showed, it is a little odd to describe them without some reference to altruism. A donation in both the lay and the tax law sense means a transfer without a material return, which I have called "weak altruism." Many traditionally recognized charities, however, derive their support not from donations, but from ordinary sales of private goods of which the payor is the consumer. In general there is no altruism on the demand side, because commercial nonprofits receive their support from the sale of goods and services to those who consume them, or to members of their immediate families, as with day care. Yet this category

¹¹⁹ And, as we have seen, some view all donations as fundamentally self-seeking. Kelman, for example, maintains that "[w]atching education be consumed is no less an act of consumption than any other form of voyeurism." Kelman, *supra* note 95, at 849. He elaborates this analogy in a footnote: "Since hiring a prostitute is clearly an act of consumption, hiring a hooker and/or a John and watching them must be also." *Id.* at 849 n.59.

¹²⁰ Even Hansmann partly explains institutions of higher education as entrepreneurial commercial nonprofits that consumers patronize in order to avoid purchasing complex, hard-to-evaluate, goods or services from for-profit firms, which have an economic incentive to trade on consumer ignorance. Hansmann, *supra* note 17, at 866. As we shall see in the next section, this explanation is simply a particular instance of Hansmann's general contract failure account of entrepreneurial commercial nonprofits.

includes many traditional charities; Hansmann gives as general examples nursing homes and community hospitals.¹²¹ His two specific examples, the National Geographic Society and the Educational Testing Service,¹²² are both charities under the federal income tax law, and at least the first also fits fairly well within the lay meaning of charity. We shall, therefore, have to look for altruism on the supply side, beginning with Type 7 organizations, the commercial entrepreneurial to which Hansmann devotes most attention.

1. Type 7 Organizations—Commercial Entrepreneurials Operated for Patrons' Benefit

Hansmann's contract failure theory accounts well for several important classes of Type 7 organizations. The first of these are suppliers of complex goods or services. As we have seen, purchasers who are unable to evaluate the quality of what they purchase will be inclined to seek nonprofit suppliers, which, given the nondistribution constraint, have no incentive to skimp on quality to increase profits. Thus, Hansmann maintains, we predictably find a proliferation of nonprofit suppliers in health care, education, and care for the young and the elderly.¹²³

One particular form of health care provider, hospitals, illustrates a second way of accounting for commercial entrepreneurial nonprofits under the contract failure theory. Hospitals, Hansmann points out, began as donative nonprofits that served essentially as sick houses for the poor. Changes in medical science and the proliferation of public and private health insurance have largely taken hospitals out of the relief business. Few hospitals now receive substantial contributions, and few provide much indigent care. But many remain nonprofit, in part, Hansmann suggests, from inertia. Thus, at least some commercial entrepreneurial nonprofits are in a sense anachronisms, fossils of donative nonprofits in environments where one would now expect to find for-profits in the ascendancy.¹²⁴

At least two other classes of commercial entrepreneurial nonprofits can be explained consistently with the contract failure theory, even though they cannot be comfortably subsumed under it. Members of one of these classes are not really nonprofits at all, but proprietary wolves in the sheep's clothing of nonprofit status. The

¹²¹ Hansmann, *supra* note 17, at 842 (chart).

¹²² *Id.*

¹²³ *Id.* at 862–68.

¹²⁴ *Id.* at 867.

strategy of the de facto owners of these pseudo-nonprofits is to skim off net profits in the guise of payments for a factor of production other than capital. The classic example is the doctor-controlled nonprofit hospital in which net earnings tend to be directed to increasing the salaries of medical staff.¹²⁵

The other form of pseudo-nonprofit arises not because its controllers want to siphon off net earnings in the guise of payments for something other than capital, but because payment for some other factor of production that they supply simply leaves no residuum. Hansmann gives as examples a solo law practitioner and the proprietor of a small, in-home day care center. In each case, the entire earnings can reasonably be treated as salaries to employees, not as a distribution of residual profits to owners.¹²⁶ Entrepreneurs in such small scale, low capital intensity industries are thus indifferent as to whether their enterprises are organized as for-profits or nonprofits.¹²⁷ Thus, "[t]he nondistribution constraint that characterizes the nonprofit form has real meaning only when an enterprise is of sufficient scale to develop large earnings that cannot

¹²⁵ *Id.* at 864-65, 868. Though this strategy would appear to be generally available to nonprofit managers, it seems to be especially prevalent in certain industries, particularly nursing homes and hospitals. See also Clarkson, *supra* note 61, at 17-18 (discussing theories of physician-controlled hospitals). For a more general analysis of the abuse of nonprofit status by insiders, see *id.*; Etzioni & Doty, *Profit in Not-For-Profit Institutions*, PHILANTHROPY MONTHLY, Feb. 1976, at 22.

¹²⁶ Hansmann, *supra* note 17, at 870-71. See also Krashinsky, *supra* note 60, at 117 (in industry of small proprietorships and partnerships, difficult to control appropriation of all net earnings as wages); Weisbrod, *Private Goods, Collective Goods: The Role of the Nonprofit Sector*, in *ECONOMICS OF NONPROPRIETARY ORGANIZATIONS*, *supra* note 33, at 139, 167-68 (nonprofit firms that primarily produce private goods tend to be either affiliates of for-profits, like trade associations, or "profit maximizers in disguise," which pay out excessive compensation to non-capital factors of production); E. JAMES & S. ROSE-ACKERMAN, *supra* note 8, at 9 ("the nonprofit versus for-profit distinction may not be very useful for small break-even providers like many child-care centers"); Ellman, *supra* note 33, at 1038-39 (many nonprofit consulting firms, like closely held firms generally, have no need to distribute dividends; they prefer to pay out all earnings as compensation and perquisites).

This is not to say that such firms never embody altruism. Ellman points out that "a group of individuals may plan to sell their professional services to deserving clients at favorable rates." Ellman, *supra* note 33, at 1022, 1039. There is, moreover, evidence to support the view that nonprofit entrepreneurs are frequently motivated by ideologically grounded concerns for others. See E. JAMES & S. ROSE-ACKERMAN, *supra* note 8, at 50-62; Rose-Ackerman, *Altruistic Nonprofit Firms in Competitive Markets: The Case of Day-Care Centers in the United States*, 9 J. CONSUMER POL'Y 291 (1986). But, in light of the foregoing, separating the sheep from the goats—not to mention the wolves—might be a serious administrative problem.

¹²⁷ Unless, perhaps, they are truly altruistic and wish to use their nonprofit status to signal consumers that they are offering their services at below-market prices. Ellman, *supra* note 33, at 1039.

easily and plausibly be paid out simply as reasonable salaries to the individuals who are in control of the enterprise."¹²⁸

But not all Type 7 commercial entrepreneurial nonprofits can thus be explained either in terms of the contract failure theory itself or in terms wholly consistent with that theory. Not all commercial entrepreneurial nonprofits supply complex goods or services like health care and education; some provide quite ordinary consumer goods. Nor are all of these the relics of donative nonprofits that have lost their contributors. And some of them operate in relatively large-scale, capital-intense industries where, if those who founded them had chosen, they might have retained a claim on true residual earnings. Finally, some are truly nonprofit; though they generate revenues over non-capital costs of production, those who control them do not skim off the excess through inflated salaries or self-dealing transactions. There is a residual class of commercial entrepreneurial nonprofits that lies outside Hansmann's explanations.

Hansmann himself gives an example of such an anomaly:

[S]uppose—to take an extreme case—that several individuals desire to organize a shoe store as a nonprofit corporation. . . . They plan to observe the nondistribution constraint scrupulously, never paying to themselves anything beyond a reasonable salary for work performed for the store. . . . The store's income will come exclusively from the prices it charges for the shoes it sells. . . . In short, the store will be a pure entrepreneurial commercial nonprofit.¹²⁹

Such organizations do not exist only in law professors' hypotheticals. Cases involving organizations claiming exemption from federal income taxation as charities provide several other examples. In one case, a family of Presbyterian ministers founded a publishing company for the promulgation of works of Calvinistic theology.¹³⁰ From a humble beginning on their dining room table, the organization eventually generated annual net revenues from book sales in excess of \$50,000 with sufficient regularity to attract the attention of the I.R.S.¹³¹ Another example is the Orton Ceramic Company.

¹²⁸ *Id.* at 871 (footnote omitted).

¹²⁹ Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 515 (1981).

¹³⁰ *Presbyterian & Reformed Publishing Co. v. Commissioner*, 743 F.2d 148 (3d Cir. 1984).

¹³¹ *Presbyterian and Reformed Publishing Co. v. Commissioner*, 79 T.C. 1070, 1075-77 (1982), *aff'd*, 743 F.2d 148, 150 (3d Cir. 1984).

Mr. Orton, an academic and entrepreneur, had developed and manufactured through a for-profit firm the pyrometric cone, which by the time of his death had become recognized as the international standard for measuring critical parts of the ceramic firing process. In his will, Orton bequeathed the cone production operation to a putatively charitable trust, with instructions that production be continued and that sales proceeds be used to further research and continue production.¹³²

Whether such examples of anomalies could be multiplied is, of course, an empirical question.¹³³ Whatever the answer, the important point for our purposes is that examples do exist. That raises another question: How does the contract failure theory account for them?

In connection with his shoe store example, Hansmann phrases the question as "[w]hy would the incorporators choose to structure such an enterprise as a nonprofit corporation?"¹³⁴ Significantly, this question, unlike his basic query about the role of nonprofits, is not phrased in terms of why purchasers would want to patronize such a nonprofit rather than its for-profit competitors. Presumably this is because none of the basic elements of contract failure is present.¹³⁵ Shoes are not public goods, their quality is easy for the purchaser to evaluate, and the purchasers are likely to be the ultimate users or at least to be in a position to know the ultimate users, as in the

¹³² 56 T.C. 147 (1971). Citing the significance of the cones in ceramic research, the tax court majority recognized the trust's charitable status; a vigorous dissent relied largely on the cases denying charitable status to non-denominational religious publishers. *Id.* at 164-70. This was the Foundation's second victory over the I.R.S., which had unsuccessfully challenged its charitable status before the enactment of the unrelated business income tax in 1950. See Edward Orton, Jr., *Ceramic Foundation v. Commissioner*, 9 T.C. 533 (1947), *aff'd*, 173 F.2d 483 (6th Cir. 1949).

¹³³ See, e.g., *The Schoger Foundation v. Commissioner*, 76 T.C. 380 (1981) (denial of charitable tax exemption to organization that operated a nonprofit vacation resort).

¹³⁴ Hansmann, *supra* note 129, at 515.

¹³⁵ It may in part, however, be on account of the context in which Hansmann discusses this example. That context is not his article explaining the role of nonprofits, but a later article arguing in favor of a broadened definition of nonprofit purposes under state nonprofit corporation codes to include examples like his shoe store. In particular, Hansmann uses the shoe store example to present "in their clearest and starkest light," Hansmann, *supra* note 129, at 516, the issues that arise when incorporation under non-profit corporation statutes is not open to all forms of lawful activity. In that context, a supply-side explanation may be more appropriate. On the other hand, he explicitly takes his contract failure theory as the basis for his later article, Hansmann, *supra* note 129, at 501-07. In neither article does he attempt to explain such organizations in demand-side terms. Moreover, it is not clear how a demand-side explanation could be extrapolated from the contract failure theory, for reasons discussed *infra* at notes 136-37 and accompanying text.

case of parents of small children. In any case, Hansmann offers his explanations of the shoe store in supply-side terms:

Perhaps because (1) they are entering the business primarily for the sake of enjoyment; (2) they have no capital of their own, so that the most that they would be likely to earn from such an enterprise under any form of organization would be a salary; and (3) they feel that the non-profit form will help assure their customers that they are charging no more than a fair price for the shoes they sell. Or perhaps they are hostile to capitalism on ideological grounds, feeling that it fosters exploitative relations between owners and workers. Or perhaps they are simply acting on a whim.¹³⁶

This discussion neither explains the anomalies in terms of contract failure nor gives another general explanation of them. Most significantly for our purposes, however, it fails to recognize their inherent altruism. We will first look at each of Hansmann's proffered alternatives, then turn to the issue of altruism.

To argue that the shoe store founders "enter the business primarily for the sake of enjoyment" may be to argue in a circle similar to that of which the "strong" altruism theorists accuse economists. If we assume that we do only those things that increase our overall utility and if we equate utility with enjoyment, then by definition everything is done "for enjoyment."

The second suggestion—that the shoe store principals saw in their enterprise no opportunity for gain beyond a reasonable salary because they had no capital to contribute—seems implausible as a general explanation. Even in the shoe store example, this seems unlikely. At least in theory, capital markets exist to fill this need; if you do not have capital of your own, you can either borrow it or sell part of the enterprise—more precisely, part of the entitlement to its residual earnings—to equity investors. You must, however, be able to offer a return on investment that, taking risk into account, is at least as good as alternative investment opportunities. Perhaps Hansmann's shoe store entrepreneurs cannot meet that condition, either because, owing to the scale of their proposed operation, the prospect of residual earnings beyond salaries and other operating expenses is grim, or because, owing to the strength of competition

¹³⁶ Hansmann, *supra* note 129, at 515.

in the industry, returns to investment in that industry are not sufficient to attract additional capital.¹³⁷

In the examples described above, however, neither condition seems to have precluded genuine profits. Presbyterian and Reformed Publishing Company eventually earned profits far enough in excess of reasonable expenses to arouse the suspicion of the I.R.S. To be sure, at the outset the founders apparently did not foresee these profits. But even if they had been more financially farsighted, they might well have chosen nonprofit status anyway. Indeed, in the case of Orton Ceramics, the organization was founded as a for-profit and continued to earn net profits even after its founder's death and its conversion to nonprofit status.

The problem with Hansmann's third alternative—that the shoe store founders chose nonprofit status to assure customers that they were getting a fair price—is the ambiguity in the idea of “fair price.” If by that he means a price reflecting the value the market places on the use of particular resources to make shoes as opposed to other products, then nonprofit status seems unnecessary. The market itself gives that assurance in the absence of some form of market failure that we have no reason to think is present here. If, however, he means to distinguish “fair price” from “market price,” then, as we shall see, I think he comes close to the heart of the matter. He does not, however, elaborate.

But he does give a hint. “Perhaps,” he suggests, the founders of the shoe store “are hostile to capitalism on ideological grounds, feeling that it fosters exploitative relations between owners and workers.”¹³⁸ Perhaps. But if the founders of Presbyterian and Reformed Publishing Company were incipient socialists, they certainly published an odd form of literature as the vehicle for their views. Though Calvinism is perhaps not inconsistent with alternative economic arrangements, its compatibility with capitalism has at least been more widely discussed.¹³⁹ A thorough-going distaste for capi-

¹³⁷ There is another possibility. Returns on investment in other industries may be so relatively high that these industries attract all investors seeking to maximize their returns. This seems unlikely in the shoe industry today, but it may well have been the case at one time in several industries, such as hospital care and education, in which nonprofits initially predominated. In this situation, an initial infusion of donated capital may be essential. See *infra* notes 215–16 and accompanying text for discussion of a similar situation in the history of financing of public goods.

¹³⁸ Hansmann, *supra* note 129, at 515.

¹³⁹ See, e.g., M. WEBER, *THE PROTESTANT ETHIC AND THE SPIRIT OF CAPITALISM* (1904); *PROTESTANTISM AND CAPITALISM* (R. Green ed. 1959).

talism is an equally unlikely account of why Mr. Orton placed his ceramic company on a nonprofit footing at his death.

Hansmann does pose a final possibility: maybe the shoe store entrepreneurs were "simply acting on a whim."¹⁴⁰ In some cases, that may quite literally be true. But as a general explanation, whims are unacceptably circular reasons; what, indeed, is a whim but the absence of a reason? As Hansmann implies by putting whims last, if a plausible affirmative reason can be offered, it should be explored. One such reason is the weak altruism I have identified in connection with donative nonprofits.

A closer look at Hansmann's shoe store reveals an element of altruism it shares with all Type 7 organizations, an element very similar to the altruism in parentalistic donative nonprofits. In the case of the shoe store, the founders may believe that, at the prevailing market price, too few shoes, or shoes of insufficient quality, are being consumed.¹⁴¹ They know that, as a matter of elementary economics, a drop in the price of shoes will, all else being the same, produce an increase in the quantity demanded. The challenge, then, is to offer their shoes at less than the market price for comparable shoes.¹⁴²

The market price, in order to keep for-profit firms in the industry, must be high enough to cover the costs of all factors of production, including a return on capital sufficient to keep investors from turning to more lucrative alternatives. The founders might lower prices in any of several ways while meeting all factor costs. One way would be to make up the revenue shortfall with donations. This is what some donative nonprofits are doing when they provide goods or services free of charge; in giving away products they are fully subsidizing consumption. Predictably, however, donations may not be a feasible way to finance a nonprofit shoe store. In all likelihood, few prospective donors will share the founders' zeal for subsidizing footwear consumption.

¹⁴⁰ Hansmann, *supra* note 129, at 515.

¹⁴¹ Hansmann explains managers' employment and entrepreneurs' investment in nonprofit service firms that provide higher quality outputs than competing for-profit firms in terms of their willingness to sacrifice higher monetary returns for the satisfaction of associating with a "craftsmanlike" output. Hansmann, *supra* note 17, at 899. As we shall see, however, he does not find anything altruistic in this sacrifice. See *infra* note 148 for a further discussion of this point.

¹⁴² If they succeed, they are likely to have to ration their output. See Rose-Ackerman, *supra* note 126, at 293. They could sell their cheaper-but-as-good-or-better shoes to those who satisfy some test of need, or they could set up their store in an area where all customers are likely to be needy. See F. GLADSTONE, *supra* note 80.

A logical alternative to increasing revenues is to reduce costs. One way to reduce costs would be to increase operating efficiency, to organize production in such a way that, for the same level of factor inputs, there is a greater output. In a competitive industry like shoe retailing, however, this probably will not succeed. Another way to reduce costs would, of course, be to obtain factors of production more cheaply than competitors. But a special break from their landlord or their wholesaler would essentially be a donation in kind, and we have already ruled out third-party donations. The shoe store owners' own labor and any other factors they themselves control is an obvious source; they could work for free or make interest-free loans to the new enterprise. But suppose they are unable or unwilling to make such sacrifices. Is there any other way for them to underprice the market?

There is another way, if we modify one of our assumptions slightly. Suppose there is one sacrifice the founders of the shoe store can afford to make—they can decline to accept their entitlement as entrepreneurs to any net profits the shoe store may generate. Or, stated another way, they can organize the store as a nonprofit. If there are any net revenues to be earned, then the price of shoes can be dropped below the market by that much. Net profits, of course, are the market price of equity investment. By organizing the shoe store as a nonprofit, its founders have in a sense avoided, or at least reduced, the cost of one factor of production, capital.¹⁴³

¹⁴³ In industries that require a relatively large initial infusion of capital (ceramic cone manufacture, for example), founders obviously cannot rely on retained earnings. A nestegg of capital must precede nonprofits of this feather. Nor are nonprofit entrepreneurs in such industries likely to be able to rely totally on the bootstrap of debt financing. In theory, as the percentage of debt financing increases, the interest rate rises to reflect the growing risk that the firm will be unable to meet its obligations. Predictably, this interest rate will consume all likely net earnings well before the percentage of debt financing reaches 100. Hansmann, *supra* note 68, at 73. Moreover, the bootstrap will probably snap even earlier, when the firm's assets cease to be adequate security for additional loans. *Id.* In industries where initial capital requirements are virtually nonexistent (selling flowers to motorists at stop-lights, for example), the only earnings retained are likely to be foregone salary "plowed back" into the enterprise. This, of course, technically violates our initial assumption of no donative financing, because the founders are in effect contributing part of the wages to which they are entitled.

To get our altruistic commercial firm off the ground, therefore, we will probably have to relax one of our initial assumptions a bit. The founders may have to attract an initial infusion of donative financing, either through outright gifts or below-market loans. Or they may initially have to provide some factor of production themselves at a below-market rate. The Presbyterian and Reformed Publishing Company founders, for example, initially worked without salary, operated out of their home without paying themselves rent, and made substantial contributions. *Presbyterian and Reformed Publishing Co. v. Commissioner*, 743 F.2d 148, 151 (3d Cir. 1984). Significantly for present purposes, however, the relaxation of any

In another sense, however, this was possible only through their "contribution" of their entitlement to net revenues. Viewed from either perspective, this much is clear: once the organization is set up on a nonprofit basis, the net revenues that otherwise would have been distributable to its founders are now committed to the purposes for which the organization was created.¹⁴⁴ Thus, the founders' initial contribution of their potential earnings has an on-going aspect; the organization embodies their altruism. Moreover, as long as it remains nonprofit, this element of altruism remains, even if all other factors of production must be purchased at market prices.

Weak altruism offers an equally plausible account of the other examples of commercial entrepreneurial nonprofits described above. Closest to the shoe store example is Presbyterian and Reformed Publishing Co. The appellate court reviewing its creators' purpose found no evidence indicating anything other than a desire to promote consumption of a particular school of theological literature.¹⁴⁵ Though prices were in most cases not set much, if any, below those of for-profit competitors, net revenues were retained for expansion of operations.¹⁴⁶ In the ceramic cone case, the terms of Mr. Orton's will provided that his foundation was to offer ceramic cones at below the return-maximizing price explicitly to stimulate

of these assumptions suggests that commercial nonprofits must be more, not less, altruistic. Not only must their founders forego entitlement to eventual profits, they may also have to find or provide more direct forms of donative financing up front.

¹⁴⁴ The purpose need not, of course, be simply providing a particular good at the lowest possible price relative to quality. The organization may also want to expand provision of its product at a given price and quality. If so, it may use its net revenues for expansion rather than solely to reduce the price it charges consumers. This seems to have been the strategy of the controllers of Presbyterian and Reformed Publishing Company, who used a substantial portion of retained earnings to purchase a larger warehouse. *Presbyterian Publishing*, 743 F.2d at 151. It may also have been the strategy of Intermountain Health Care, a regional health care organization that apparently charged at or near market rates and used net revenues for expansion of services and facilities. *Utah County v. Intermountain Health Care, Inc.*, 709 P.2d 265, 272-76 (Utah 1985). Expansion could permit the organization to achieve greater economies of scale and thus to charge lower prices per unit in the longer run, but it need not. It may simply be a means of providing the same good or service to a wider clientele at the same price.

There is a darker prospect, however. If empire-building ambitions motivate nonprofit managers, they may trade off operating efficiency for size, increasing size beyond the point at which expansion begins to pay diminishing returns. This would result in a net increase in the price consumers pay for the organization's product. Young, *Entrepreneurship and the Behavior of Nonprofit Organizations: Elements of a Theory*, in *THE ECONOMICS OF NONPROFIT INSTITUTIONS*, *supra* note 33, at 161.

¹⁴⁵ *Presbyterian Publishing*, 743 F.2d at 158.

¹⁴⁶ *Id.* at 152, 156-58.

consumption as a means of promoting research in Mr. Orton's preferred field.¹⁴⁷

It is important, however, to note that the altruism that accounts for these organizations is weak altruism. We cannot be sure that the founders of commercial entrepreneurial nonprofits are not acting ultimately out of a self-regarding preference, any more than we can be sure in the case of contributors to donative nonprofits. God alone (if anyone) knows whether the Craig family in founding Presbyterian and Reformed Publishing Company and Carnegie in placing organs in dozens of Presbyterian churches were trying to feather their celestial nests or to further the interests of their fellowfolk. All we can say with certainty is that both the founder and the donor make a sacrifice in money or money's worth without material reward. To assume—or insist—that each is taking his compensation in another, non-material form is entirely consistent with the weak form of altruism.¹⁴⁸

But, with respect to the founders of commercial entrepreneurial nonprofits, can we say even that this much is invariably true? It may well be objected that, although weak altruism is a plausible account of the motives of nonprofit founders, it is no more necessary an account than any of Hansmann's alternatives. As I said at the outset, the founders of each of the organizations discussed *may* have thought the good or service in question was being undercon-

¹⁴⁷ Edward Orton, Jr., *Ceramic Foundation v. Commissioner*, 56 T.C. 147, 149–50 (1971).

¹⁴⁸ Thus, for example, in an appendix entitled "Signaling and Screening," Hansmann posits that potential managers or entrepreneurs in a given service industry are of two types. Hansmann, *supra* note 17, at 899–901. The first are "greedy"; they are "interested only in money and will pursue whatever vocation [or, if they are entrepreneurs rather than managers, whatever investment] pays the most." *Id.* at 899. The second are "craftsmanlike"; they are "interested not only in money, but also in the quality of service produced by the institutions they manage [or in which they invest]." *Id.* Each kind has equivalent opportunities for employment, and in the case of entrepreneurs, investment, in other sectors. *Id.* The greedies will thus work (or invest) in a nonprofit firm only if it offers compensation at least equal to the expected monetary return on their labor or capital in alternative sectors. *Id.* The craftsmanlike, on the other hand, will accept a lower monetary return if it is offset by a higher level of quality. *Id.* This is, in Hansmann's terms, because "they take positive satisfaction in operating a high-quality institution." *Id.*

Note, however, that whatever their subjective reason for accepting below-market compensation may be, the fact remains that they do in fact accept it. This fact is all that "weak" altruism insists on. As Weisbrod has observed,

One . . . element in a collective nonprofit's behavioral model appears to be the preference of its manager entrepreneurs to accept lower-than-market returns in exchange for the utility from engaging personally in "public-interest," external-benefit-generating activities. In effect, the manager-entrepreneurs of collective nonprofits may be giving in-kind gifts.

Weisbrod, *supra* note 126, at 167 (footnote omitted).

sumed, and they *may* have sought to remedy the problem by subsidizing consumption. But, as Hansmann suggests, they may have set up their organizations as hobbies, or as larks, or as thorns in the flesh of capitalists. Undeniably, motives of nonprofit entrepreneurs are notoriously varied and very often mixed.¹⁴⁹ Is weak altruism, then, just one among several plausible accounts of nonprofit entrepreneurial commercial activity, an account that may be empirically true in some cases but not necessarily true in any?

No. Whenever an organization with the potential to return profit to its founders is set up on a nonprofit basis, the founders have necessarily forgone that potential profit. Moreover, as long as the organization continues to abide by the nondistribution constraint, its potential profits are available for subsidizing the purchases of its patrons. This is not only true of the anomalous commercial entrepreneurial nonprofits that are problematic for Hansmann's contract failure theory, those that produce ordinary private goods easily evaluated by the buyer. It is also true of those that Hansmann's theory explains best, like hospitals, nursing homes, and educational organizations, that provide complex goods and services. Moreover, it is conceivable that such organizations could exist in any industry in which the scale or capital-intensity produces returns significantly above controllers' salaries.¹⁵⁰

But there are significant peculiarities about the inevitable altruism I have identified, some theoretical, others practical. Unlike Hansmann's contract failure theory, the weak altruism account does not purport to be a causal explanation of why commercial entrepreneurial nonprofits arise. Rather, and less ambitiously, it merely points to a characteristic they share. But both entrepreneurial and mutual donative nonprofits also share this characteristic, and it may have important implications for their treatment under the federal income tax.

Still on the theoretical side, it is important to emphasize the relatively constrained conditions under which altruism is automatic in commercial entrepreneurial. As I discussed earlier, there must be the potential for the organization to return a net profit to found-

¹⁴⁹ Dennis Young has extensively analyzed the motivations of nonprofit entrepreneurs and has offered a detailed set of stereotypical motivation patterns. D. YOUNG, *IF NOT FOR PROFIT, FOR WHAT: A BEHAVIORAL THEORY OF THE NONPROFIT SECTOR BASED ON ENTREPRENEURSHIP* (1983); see also Young, *supra* note 144.

¹⁵⁰ See, e.g., *Dodge v. Ford Motor Co.*, 204 Mich. 459, 170 N.W. 668 (1919) (derivative suit alleging, among other things, that Ford management was reducing distributions to shareholders in order to benefit automobile consumers and others).

ers above the costs of non-capital factors of production. Sometimes the nature of an industry, or the structure of some firms within the industry, will effectively preclude this possibility. As Hansmann points out, this seems to be true of solo law practitioners and much of the day-care industry.

On the practical side, this theoretically identifiable condition may be difficult to identify and monitor in particular cases. The requisite level of scale or capital intensity would have to be set somewhat arbitrarily. The spectrum running from solo medical practitioners through modest outpatient facilities to the Mayo Clinic may have no radical breaks; the same may be true of the spectrum that has struggling religious publishers on one end and large denominational presses on the other. Once again, however, the extremes are fairly clear, as is the principle on the basis of which the line in the middle would have to be drawn. Moreover, as we shall see in section V, some nonprofits that clearly lie on the capital-intensive, large scale side of the line—hospitals, for example—are being asked to justify their tax exempt status in terms of differences from their for-profit counterparts.

2. Type 6 Organizations—Commercial Entrepreneurials Operated for the Benefit of Non-Patrons

All the Type 7 organizations described above conferred their benefits upon their customers in the form of below-market prices subsidized by forgone profits. Hansmann's demand-side analysis of entrepreneurial commercials suggests that customer benefit should be their *raison d'être*, on the theory that purchasers of complex goods prefer to deal with nonprofits, which have no profit-motivated incentive to overcharge. But Hansmann's nondistribution constraint operates only negatively, to forbid the organization's controllers from using such profits to materially benefit themselves, not positively, to dictate those for whose benefit profits must be used.

Logically, the controllers could expend these profits to benefit neither themselves nor the organizations' customers, but third parties. These third parties might be consumers of a different good or service provided by the same organization, as in the case of museum gift shops that subsidize museum operations. Or they might be consumers of the goods or services of another organization to which the net revenues of the first are directed, like the students of New York University's law school whose studies were in part underwrit-

ten by the law school's pasta business.¹⁵¹ In either case, profits from sales to the purchasers of the first product or service might be used to subsidize those who consume the second.

Hansmann acknowledges this possibility and treats it as a threat to the fundamental purpose of entrepreneurial nonprofits in at least one context, that of the nonprofit hospital. Fairly commonly, he points out, "profits derived from services provided to private-room patients and to patients with relatively routine problems may be used to help cover the costs of teaching, research, unusually expensive forms of treatment, and services provided to indigent patients."¹⁵² He finds several factors mitigating this departure from direct consumer benefit—the benefitted class does not control the organization and those who do control the organization do not directly benefit.¹⁵³ He notes, however, that the latter class—doctors and hospital administrators—may indirectly benefit from cross-subsidies, and he argues that in any case cross-subsidies are less problematic "if the patrons who are the source of the subsidy are aware of its existence and have some choice about contributing to it."¹⁵⁴ These conditions of informed consent, he maintains, frequently do not obtain in the hospital industry.¹⁵⁵

As Hansmann readily concedes, however, these conditions do obtain in other industries,¹⁵⁶ and such cross-subsidization is fairly common in nonprofits.¹⁵⁷ Indeed, exploitative cross-subsidization seems unlikely whenever the goods or services are easily evaluated by the consumer and available from alternative suppliers.¹⁵⁸ Moreover, cross-subsidization may involve an affirmative consumer preference. Consider an example. Assume that the Florida Museum of Natural History and Tiffany's both have a Christmas catalogue, each of which lists for the same price a reproduction mummy made by

¹⁵¹ C.F. Mueller Co. v. Commissioner, 190 F.2d 120, 120-21 (3d Cir. 1951).

¹⁵² Hansmann, *supra* note 129, at 560-61.

¹⁵³ *Id.* at 561.

¹⁵⁴ *Id.* at 562.

¹⁵⁵ *Id.*

¹⁵⁶ *Id.* at 563.

¹⁵⁷ Ellman, *supra* note 33, at 1027-28; *see also*, E. JAMES, CROSS-SUBSIDIZATION BY NON-PROFIT ORGANIZATIONS: THEORY, EVIDENCE, AND EVALUATION (Yale University Institute for Social and Policy Studies Program on Nonprofit Organizations Working Paper No. 30, 1982).

¹⁵⁸ Ellman, *supra* note 33, at 1026-27. Ellman argues that hospitals, on which Hansmann bases much of his discussion of cross-subsidization, may well be a fairly unusual case, primarily because a third party, either the government or a private insurer, frequently pays for the services provided. *Id.* at 1031 n.72.

a particular artist. Also assume that the purchaser is not entitled to a charitable deduction for any part of the purchase price paid the museum.¹⁵⁹ Finally, assume that the museum's catalogue sales revenues are subject to federal income tax at the same rate as Tiffany's. Why might some consumers prefer to buy the same item at the same price from the museum? Quite rationally, they may prefer to have the profits from the sale go to the museum, which they assume will use them for subsidizing its museum operations and which, in any case, is unable to distribute residual returns to controlling individuals.¹⁶⁰

3. Type 8 Organizations—Commercial Entrepreneurials Operated for the Benefit of Controllers

Hansmann's discussions of cross-subsidization in both the hospital and museum shop contexts explicitly assume that those who control the organization do not use net receipts for their own benefit.¹⁶¹ Without this assumption, would it make sense to call such an organization a nonprofit? In many respects, it would resemble a garden-variety for-profit. Its revenues would come from commercial, nondonative transactions and would be available for use by those who control it. It lacks the obvious altruism of donatively supported nonprofits; it also lacks the altruism characteristic of Type 6 and 7 commercial nonprofits, in which controllers use sales proceeds to benefit others. As we saw in connection with Type 2 organizations, however, altruism may lie in the socialization of assets or the provision of public goods. And as we saw in connection with Type 7 organizations, giving up entitlement to profits is in a sense altruistic. The combination of these factors adds up to a measure of altruism. An example of activities conducted within these constraints would be a church's Christmas bazaar that relied on sales

¹⁵⁹ The reason for the denial of any charitable deduction is that the purchase price of the reproduction mummy equals its fair market value, and thus contains no gift component. See *supra* note 92 for a discussion of the requirements for making a tax-deductible gift.

¹⁶⁰ Hansmann offers a similar museum shop example and acknowledges both that purchases from alternate, for-profit suppliers would involve a "profit" to cover an economically competitive return on investment and that purchasers may consciously want to direct this "profit" to charity. Hansmann, *supra* note 129, at 563. Hansmann views this as an innocuous form of cross-subsidization on the theory that patrons implicitly consent or at least have other alternative sources, though he expresses reservations about the tax exemption of their receipts. *Id.* Ellman views the cross-subsidization in the case of museum shops as innocuous because the transactions involve ordinary, easily evaluated consumer goods. Ellman, *supra* note 33, at 1024-25.

¹⁶¹ Hansmann, *supra* note 129, at 561, 563.

to nonmembers to subsidize its members' benefits, if those benefits either were public goods or were private goods distributed to individuals through a collective decision-making process.

E. *Commercial Mutuals—Altruism and Beyond*

In this category of nonprofits, Hansmann's fourth and last, the mode of finance is the sale of goods or services, and the locus of control is the purchasers. The locus of benefit issue divides this category into two subspecies, commercial mutuals that operate for the benefit of their patrons and those that operate for the benefit of others. We will consider first the latter subspecies, which Hansmann tends to ignore.

1. Type 9 Organizations—Commercial Mutuals Operated for the Benefit of Non-Patrons

Imagine a congregationally controlled church that operates a book store where members can buy the great works of Calvinistic theology. Like the controllers of Presbyterian and Reformed Publishing Company, the members of the church could use any net revenues from the sale of books to expand their operation. Alternatively, like Hansmann's nonprofit shoe store entrepreneurs, they could forego any such net profit by charging lower prices and thus subsidizing the purchase of books. Or—and this is the critical turn—they could charge a market price, thus producing a margin of (non-economic) profit that they could use to support missionary work or a homeless shelter. If the members paid a competitive price for the books, this would simply be another example of the "profit direction" we saw above in connection with museum shops. Books, in fact, figure prominently in the wares of museum shops and, to make the parallel closer, we can imagine a "church shop" that sells not only books, but icons and other religious paraphernalia. The key difference for purposes of the present analysis is that the museum shop is an entrepreneurial commercial; the church shop, a mutual. The former sells primarily to others than those who control it; the latter sells primarily to its members. The similarity is that they both use the net revenues to benefit third parties; in that respect, they are both altruistic.

Within the larger context of donative mutual nonprofits like congregational churches, the use of such commercial operations to tap members' willingness to direct profits for the benefit of others is probably fairly common. Holiday bazaars for the benefit of the

needy are an obvious example. Such operations need not, however, be small, seasonal, or informal. The American Bar Endowment's insurance program is an example of a large, lucrative, and highly sophisticated operation that, but for these differences in scale, quite resembles our church shop example.¹⁶²

2. Type 10 Organizations—Commercial Mutuals Operated for the Benefit of Patrons¹⁶³

Probably the more common locus of benefit in mutual commercial nonprofits is, as Hansmann's discussion suggests, the purchasers themselves. Hansmann has identified two distinct situations in which purchasers might seek control. The first is simply the "complex goods" form of contract failure. When, as we have seen in connection with entrepreneurial commercials like hospitals, the good or service provided is difficult for the purchaser to evaluate, for-profit firms have an incentive to skimp, and purchasers will tend to prefer nonprofit suppliers. According to Hansmann, organizing the commercial provision of hard-to-evaluate goods and services in a mutual, as opposed to an entrepreneurial, nonprofit gives patrons an added measure of assurance that such information asymmetries will not be exploited to their disadvantage.¹⁶⁴ Thus, for example, parents may seek this added assurance when they choose mutual day care providers.¹⁶⁵

Ira Ellman offers a significantly different account of mutual day care.¹⁶⁶ According to Ellman, the parents who found a mutual nonprofit day care center seek control of the organization not primarily because they cannot monitor output, but rather because "it would be difficult for the buyer to specify his preferences in advance, both because it would be administratively tedious to spell out such detail in a contract and because the specific issues are difficult

¹⁶² For a description of the program, see *United States v. American Bar Endowment*, 477 U.S. 105, 106–09 (1986). During the period in question, members of the American Bar Association bought group insurance from the Endowment and contributed annual experience rebates to the Endowment. The Endowment, a charitable organization exempt from federal income tax under sections 501(a) and (c)(3) of the I.R.C., used the proceeds from the program to underwrite research and law reform projects, primarily through grants to other charitable organizations.

¹⁶³ As I describe in greater detail below, see *infra* notes 337–38 and accompanying text, Type 10 Organizations overlap extensively with what Bittker and Rahdert call "mutual benefit organizations." See Bittker and Rahdert, *supra* note 90, at 305.

¹⁶⁴ Hansmann, *supra* note 17, at 890–91.

¹⁶⁵ *Id.*

¹⁶⁶ Ellman, *supra* note 33, at 1032–42.

to anticipate."¹⁶⁷ Hansmann insists that this problem is just a special case of contract failure,¹⁶⁸ but Ellman seems to have the better view. To be sure, one source of contract failure that Hansmann has identified is consumers' inability, at reasonable cost, to "reach a clear agreement with the chosen firm concerning the goods or services that the firm is to provide and the price to be paid."¹⁶⁹ But Ellman's point is not that there is no contract failure problem in the mutual day care context. Rather, his point is that, in solving that problem, mutual provision of the service is of far more importance than the nondistribution constraint.

The nondistribution constraint primarily operates negatively, to ensure that parents' payments are not siphoned off as extra profits. It operates positively only to the limited extent of ensuring that potential profits are in some way used within the day care center. Thus, in Ellman's words,

The [entrepreneurial] nonprofit might spend more per child on care, but do so in ways that the potential parent-purchaser does not believe yield better day care. For example, it might buy more expensive toys, but ones that the parent thinks are undesirable; it might pay its staff more, yet choose staff with a child care philosophy that the parent opposes. In sum, the heightened fiduciary obligations called for by the contract failure model do not serve the needs of parent-purchasers.¹⁷⁰

According to Ellman, what the parents really want is "management with good judgment and compatible values,"¹⁷¹ and to get what they want, they need control of the service-providing organization. This control is available through a mutual nonprofit, but not through either a for-profit or an entrepreneurial nonprofit.¹⁷²

¹⁶⁷ *Id.* at 1035. Ellman offers a similar explanation of social clubs. In that context as well, according to Ellman, members are seeking to buy something that is hard to specify in advance. Thus, "especially where members are concerned about intangible qualities, such as social class, the members might be more confident that their goal will be served in a club run by a member-chosen board than one run by outsiders seeking to maximize profits." *Id.* at 1046. For a discussion of Hansmann's account of social clubs, see *infra* notes 173-74 and accompanying text.

¹⁶⁸ H. HANSMANN, *supra* note 55, at 19 n.32.

¹⁶⁹ Hansmann, *supra* note 17, at 843.

¹⁷⁰ Ellman, *supra* note 33, at 1034.

¹⁷¹ *Id.* at 1035.

¹⁷² This is not to say, however, that parents will not likely choose to operate under the nondistribution constraint. They will, in Ellman's view, but not for the same reason as those who found donative nonprofits. Donative nonprofits need the nondistribution constraint to

Ellman's account of mutualized day care is an insightful correction of Hansmann's general account of commercial mutual nonprofits. It may, however, be limited to mutuals that produce know-it-when-I-see-it products, goods or services the quality of which not only lies in the eyes of the beholder, but cannot be adequately described to others. This would leave Hansmann's theory intact as to complex goods and services that the consumer is not personally in a favorable position to assess, but that can be assessed by knowledgeable experts in terms of objective criteria. Purchasers of day care may place more confidence in their own judgment than in the opinion of any conceivable body of experts; this is less likely to be true of candidates for open heart surgery.

But mutual commercials, like entrepreneurial commercials, do not always produce goods and services that are difficult for the consumer to evaluate. Many produce garden-variety private goods and services that are also available from for-profit suppliers. Hansmann's favorite example is social clubs, which provide many services otherwise available from for-profit restaurants, hotels, and resorts.¹⁷³ Why do nonprofits arise in this context where the contract failure theory would lead us to least expect them?

Hansmann concedes that such organizations are the one significant exception to his contract-failure account of nonprofits. His alternative explanation is that proprietors of highly exclusive clubs have a degree of monopoly power that patrons try to avoid through mutual provision of the same services. In any given geographic area, Hansmann argues, social clubs will be stratified, with higher-status individuals in higher-status, more exclusive clubs. This gives the proprietors of the more exclusive clubs an opportunity to charge

assure their donors that equity investors will not skim off contributions; the founders of mutual nonprofits, in Ellman's view, need the nondistribution constraint to ensure that they themselves, not outside investors, control the organization. *Id.* at 1036-37.

Ellman does not explain why the desire to avoid interference by non-consumers in management leads the founders of mutualized day care providers to choose nonprofit status rather than alternative means that might meet that concern equally well. They might, for example, organize as a for-profit, restrict ownership of voting common stock to consumers of the firm's services, and sell non-voting preferred stock to outside investors. A less distinct but, for our purposes, more interesting alternative would be to organize as neither a for-profit nor a nonprofit, but as a cooperative. This would allow cash rebates to consumer-owners, not just the in-kind rebates that Ellman notes are available to members of mutual benefit nonprofit organizations. Ellman, *supra* note 33, at 1037.

Ellman does mention that nonprofit organizations may enjoy more favorable tax status and pay lower corporate filing fees, but he dismisses these advantages because they are "not structural attributes of the nonprofit form . . ." *Id.* at 1036 n.80.

¹⁷³ Hansmann, *supra* note 17, at 892.

members a premium well above costs and thus to extract a monopoly profit by selling them their own high status. To avoid such exploitation, members have an incentive to seek control of production by organizing a mutual nonprofit.¹⁷⁴ Hansmann argues that essentially the same phenomenon accounts for consumer cooperatives;¹⁷⁵ indeed, he maintains that nonprofits that arise in response to the monopoly problem are the functional equivalent of consumer co-ops.¹⁷⁶

There is yet another explanation that accounts for some mutual commercials, and perhaps for an aspect of all of them. This explanation takes an important product of the organization to be the mutuality of the enterprise itself, irrespective of any additional good it purports to provide. Thus, according to Ellman,

For social clubs, the process of self-government itself may be the goal. The meetings, elections, and discussions provide an occasion for socializing and a sense of joint enterprise, which might be the very thing the members seek to buy.¹⁷⁷

And Hansmann concurs:

[T]he running of an organization may itself be a consumption item of value to the organization's supporters. The primary motivation for fraternal lodges, for example, is probably just the camaraderie and diversion involved in keeping them going; the ends ostensibly served by such organizations often seem to be little more than an excuse for setting them up.¹⁷⁸

Here again, we see that the primary purpose of some mutuals is the benefit of their members in a way that hardly qualifies as altruistic.¹⁷⁹

¹⁷⁴ *Id.* at 893-94. Hansmann suggests that the same monopoly-avoidance phenomenon may occur in other contexts that involve the key elements of exclusivity and stratification. Other examples in the nonprofit area are hospital staffs and university faculties and student bodies. *Id.* at 894.

For an elaboration of this and other circumstances under which consumer control of production produces greater consumer welfare than purchasing from for-profit firms, see Ben-Ner, *Nonprofit Organizations: Why Do They Exist in Market Economies?*, in *THE ECONOMICS OF NONPROFIT INSTITUTIONS*, *supra* note 33.

¹⁷⁵ Hansmann, *supra* note 17, at 889-90.

¹⁷⁶ *Id.* at 893-94; H. HANSMANN, *supra* note 55, at 25.

¹⁷⁷ Ellman, *supra* note 33, at 1046.

¹⁷⁸ Hansmann, *supra* note 17, at 891.

¹⁷⁹ Moreover, we shall see *infra* at note 354 and accompanying text that mutualism can

F. *Type 10 Organizations as the Limiting Case of Nonprofit Status*

Hansmann thus gives three plausible and compatible accounts of why mutual commercial nonprofits arise; Ellman offers a fourth. For the most part, these theories are complementary.¹⁸⁰ Moreover, each of them takes account of a feature that distinguishes Type 10 organizations from all the other kinds of nonprofits we have examined: they arise and operate essentially for the benefit of their members. Conversely, they lack an essential element of altruism in any of its various manifestations. First, Type 10s provide their members with ordinary consumer goods, not public goods, payment for which necessarily subsidizes others' consumption. Furthermore, Type 10 organizations provide ordinary private goods without significant elements of socialization; the level of goods and services that members are entitled to receive is directly related to what they pay, not contingent on either a collective decision-making process or the level of others' payments. Finally, Type 10 organizations involve no redistributive transfers, either in the form of donations (as with Type 1, 3, and 4 nonprofits), foregone profits (as with Type 7), or cross-subsidization (as in Type 6).

Although they lack altruism, Type 10 organizations are nevertheless nonprofit, and in a way that casts important light on the essence of nonprofit status. Here the non-distribution constraint is at its weakest—net revenues are being used for the benefit of those who control the organization. But this still means that the mutualized day care center operates differently from a for-profit alternative, in two ways. The more obvious, but less significant, difference is the form in which the organization's benefits are conferred without compensation on its controllers. The nonprofit day care center may only distribute benefits to its members, who are by hypothesis

be seen as a socially desirable attribute of Type 10 organizations, quite apart from the satisfaction members derive from them.

¹⁸⁰ As Hansmann points out, Ellman's basic disagreement with him is less about the role of commercial mutual nonprofits than about the proper structuring of nonprofit corporation statutes to ensure that they fulfill that role. According to Hansmann, commercial mutuals that arise in response to contract failure should operate under the same strict fiduciary constraints as donative nonprofits, constraints that basically mirror traditional charitable trust law. According to Ellman, such strict constraints are an unnecessary impediment. In his view, the members of commercial mutuals themselves will keep the managers in line. Nonprofit corporation law only has to "ensure that the members actually control the corporation" by "guarantee[ing] some minimal level of member democracy." Ellman, *supra* note 33, at 1041. For our purposes, the critical point is that both Hansmann's and Ellman's descriptive accounts emphasize that Type 10 organizations are designed and operated to benefit their members.

its controllers, in kind.¹⁸¹ More or better day care is what these members get. By contrast, those who control a for-profit day care center are entitled to receive its net revenues in cash.

The second, and more significant, difference between mutual commercial nonprofits and for-profits is in the locus of their benefits. Both for-profits and Type 10 nonprofits are operated for the benefit of their controllers; the interesting locus of benefit issue is the relationship of their purchasers and their controller-beneficiaries. The ultimate beneficiaries of for-profit firms, their owners, derive their net profits from sales to third parties. Any identity between owners of a for-profit firm and purchasers of its products is purely accidental; owners of a for-profit day care center may place their own children in their company's care, or they may use the profits from the firm to hire themselves nannies.

In Type 10 organizations, by contrast, the classes of purchasers and controller-beneficiaries are necessarily the same. As in for-profit firms, the net benefits ultimately come from purchasers of the good or service the organization provides, in the form of the excess of sales revenues over the cost of all factors of production. But in the case of the Type 10 organization, these net benefits return to their source. In that way, they are more like rebates than profits. Thus, to return to the day care example, any excess of revenues over costs redounds to the benefit of the parents who patronize the nonprofit, rather than to owners, as in the for-profit.¹⁸²

We have thus identified two differences between Type 10 mutual commercial nonprofits and for-profits: first, the form in which the controlling group receives net benefits and second, the relationship between the controlling group and the organization's purchasers. These two differences also provide useful criteria for comparing Type 10 organizations and for-profits with two other forms of organization, consumer cooperatives and producer cooperatives.¹⁸³

¹⁸¹ Ellman makes the same point in a somewhat different connection. Ellman, *supra* note 33, at 1037. In his view, mutual benefit nonprofits share with donative nonprofits the nondistribution constraint, but for a very different reason. For donatives, the nondistribution constraint is part of a larger package of rules essentially designed to attract contributions by barring self-dealing. For mutuals, the same constraint is part of a package of rules intended to ensure consumer control, which for Ellman is the essence of mutual benefit organizations. *Id.*; see *supra* note 172 for a further discussion of the nondistribution constraint in mutual benefit organizations.

¹⁸² As we shall see in notes 343-47 and accompanying text, *infra*, it is this feature that some commentators see as the basis of Type 10 organization's tax exemption.

¹⁸³ This comparison takes us a bit afield of our primary focus, altruistic nonprofits, and thus deserves an explanation. Hansmann and Ellman, from whose debate on mutual com-

Like Type 10 nonprofits but unlike for-profits, consumer cooperatives demonstrate an identity of controller-beneficiaries and purchasers; consumer co-ops distribute their net revenues to patrons in the form of either rebates or lower prices. The only significant difference between consumer co-ops and Type 10 organizations is the form in which these net revenues are distributable to patrons. Consumer co-ops may make distributions in cash; Type 10 organizations must make them in kind.¹⁸⁴

Why, then, is the mutual nonprofit form chosen in some contexts and the cooperative in others? Hansmann suggests several reasons. Because some mutual organizations may never have a need to make cash distributions, the cooperative form would offer them no advantages. Also, owing to the peculiar evolution of cooperatives in this country, the laws of some states may not permit certain kinds of activities, including social clubs, to be organized on a cooperative basis. Finally, the nonprofit form may in some cases confer tax advantages.¹⁸⁵

Producer co-ops, by contrast, much more closely resemble for-profit firms. Both may make cash distributions to their controller-beneficiaries; in this they resemble consumer co-ops. The critical difference between consumer co-ops and Type 10 nonprofits on the one hand and producer co-ops and for-profits on the other is the relationship between their patrons and their controller-beneficiaries. The classes of patrons and controller-beneficiaries are sep-

mercial nonprofits I have derived much of my own discussion of this kind of nonprofit, differ sharply on the descriptive issue of the extent to which these organizations serve the same functions as cooperatives and on the normative issue of the degree to which they should be governed by similar fiduciary standards. Ellman, *supra* note 33, at 1047-49; H. HANSMANN, *supra* note 55, at 29-36. Ellman is essentially agnostic about the role of consumer cooperatives. Ellman, *supra* note 33, at 1047. Hansmann describes them as essentially a monopoly-avoidance mechanism. Hansmann, *supra* note 17, at 889-90.

I take up the descriptive issue here to place nonprofits—both altruistic and mutual benefit—in a larger institutional context as groundwork for my discussion below of a different normative question, the basis for the tax exemption of nonprofit organizations.

¹⁸⁴ This is a slight oversimplification. It is an oversimplification because, as Hansmann points out, some state statutes allow cooperatives to make distributions of net revenues to contributors of capital. Hansmann, *supra* note 17, at 889. But it is only a slight oversimplification, because such statutes usually limit the rate of return to capital investors. *Id.* Thus, as Hansmann concludes, "the typical [consumer] cooperative is a limited-profit enterprise so far as investors of capital are concerned; earnings in excess of the amounts distributable to investors must be reinvested or returned to patrons." *Id.*

¹⁸⁵ *Id.* at 893. The last of these reasons for choosing nonprofit status—tax advantages—raises two further questions: first, why should mutual nonprofits enjoy an advantageous tax status; and second, why should they enjoy a more advantageous status than cooperatives, if the two are functionally so similar? I address the first of these issues in section V.

arate in both producer co-ops and for-profits and identical in both consumer co-ops and Type 10 nonprofits. Like for-profits, producer co-ops derive their revenues from sales to a class of purchasers who are not necessarily coterminous with the class of those who receive the benefits of the organizations' net profits. Just as an owner of a for-profit day care center need never purchase its child care services, so a member of the Maui Macadamia Marketing Cooperative need not eat cocktail nuts.¹⁸⁶

G. Summary—A Taxonomy of Nonprofits in Terms of Altruism

In this section we have seen that adding a third factor, the locus of benefits that nonprofits provide, to Hansmann's two factors, means of finance and locus of control, produces a ten-part division of the nonprofit world. That world consists of two hemispheres, mutual benefit nonprofits and altruistic nonprofits. The defining characteristic of mutual nonprofits (Type 10) is the sale of private goods to members.

By contrast, the essence of altruistic organizations is the conferring of uncompensated benefits. The role of altruism is clearest in donative organizations that benefit a class other than their members, whether control is in the hands of donors themselves (Type

¹⁸⁶ What then, distinguishes for-profits from producer co-ops, if they are alike in terms of the two criteria I have identified? First of all, I do not mean to suggest that these two criteria capture all relevant distinctions among non-altruistic organizations. To suggest a more complex classification scheme would be beyond the scope of this paper; I address the various differences of non-altruistic firms primarily to cast light on the nature of altruistic firms. There is, however, one salient difference between for-profits and producer co-ops that warrants mentioning here. For-profit firms seem generally to involve a relatively greater degree of vertical integration. See Krashinsky, *supra* note 60, at 123 (discussing trade associations as a form of partial vertical integration to perform limited functions).

One plausible reason for this partial vertical integration, which nicely complements Hansmann's monopoly avoidance theory of consumer co-ops, is that producers sometimes face monopsonists at the distributional phase. If this is true, then the adage that farmers buy at retail and sell at wholesale, I.R.S. Exempt Organizations Handbook (I.R.M. 7751) § (44)12(1) (1989), would more accurately be phrased in terms of their buying from monopolists (or oligopolists) and selling to monopsonists (or oligopsonists). See Baumer, Masson, & Masson, *Curdling the Competition: An Economic and Legal Analysis of the Antitrust Exemption for Agriculture*, 31 VILL. L. REV. 183, 185 (1986); Porter & Schully, *Economic Efficiency in Cooperatives*, 30 J. L. & ECON. 489, 489 (1987); Comment, *Agricultural Cooperatives: Price-Fixing and the Antitrust Exemption*, 11 U.C. DAVIS L. REV. 537, 537-38 (1978). Ben-Ner has explained a different kind of producer cooperative, "an organization controlled by member-workers who share profits among themselves," differently: "workers own and control capital in order to increase their welfare by internalizing the conflicts of interest between labor and owners of firms." Ben-Ner, *Producer Cooperatives: Why Do They Exist in Capitalist Economies?*, in THE NONPROFIT SECTOR, *supra* note 2, at 434.

4), beneficiaries (Type 3), or third parties (Type 1). Altruism can also be found in both entrepreneurial (Type 2) and mutual (Type 5) donatives that benefit the donors themselves, but only under very special circumstances. Either the benefits must be in the form of public goods, as with listener-sponsored radio, or individual donors' receipt of benefits must be independent of their gifts, as in the case of needy congregants who receive their churches' relief without regard to their own contributions. Even though, in the latter case, the benefits provided are private goods, the provision is "socialized."

Altruism is not limited to donative nonprofits. Entrepreneurial commercials—commercials not controlled by those who purchase their products—can confer uncompensated benefits either on their own customers, in the form of lower prices or higher quality (Type 7), or on third parties, in the form of cross-subsidization (Type 6). Genuinely nonprofit hospitals are examples of the former; NYU's operation of the Mueller Macaroni Company illustrates the latter.¹⁸⁷ As we saw in the case of Type 8 organizations, an entrepreneurial commercial can also use the proceeds of its sales for the benefit of its controllers. But for such an organization to be altruistic, the benefits would have to be either public goods or socialized private goods. Finally, mutual commercial organizations exhibit altruism if they use the proceeds from their sales to member-controllers to benefit others, as arguably occurs on a small scale in church bazaars and a large scale in the American Bar Endowment's insurance program (Type 9).

IV. THE NEED FOR ALTRUISTIC ORGANIZATIONS

The previous section examined the role of altruism in a range of nonprofit organizations. Focusing on the locus of benefits they provide, I identified nine kinds of altruistic nonprofits and compared altruistic nonprofits generally with other nonprofit organizations, and with consumer co-ops, producer co-ops, and for-profit firms. With respect to donative nonprofits, we had little difficulty discovering altruism on the demand side, in the fact that those who pay for the goods that such organizations provide are willing to let others enjoy them. To discover the role of altruism in commercial nonprofits, however, we had to look to the supply side, to the potential profits foregone by the founders of the organization. And we saw that even donative nonprofits can be characterized as supply-

¹⁸⁷ *C.F. Mueller Co. v. Commissioner*, 190 F.2d 120, 121 (3d Cir. 1951).

side phenomena, with ordinary donors giving fungible dollars that organizations use to purchase various factors of production.

In this section we will look at several other supply-side aspects of altruistic nonprofits, aspects that occur in all categories of altruistic nonprofits. The first of these is the altruistic supply of capital; the second is the integration of altruistic undertakings, both horizontally and vertically. These supply-side phenomena shed helpful light on the importance of the kinds of altruistic nonprofits we have already examined, those engaged in the provision of goods and services. In addition, they also illuminate the role of private foundations, altruistic nonprofits whose principle role is to provide capital to other nonprofits rather than to produce goods and services themselves.

The purpose of this section, however, is neither to give a comprehensive supply-side account of altruistic nonprofits nor to explain the mainsprings of altruistic supply.¹⁸⁸ It is, rather, to show how altruistic organizations help overcome several obstacles that individual altruists face. Thus, having in the last part seen that many different kinds of nonprofits embody altruism, we will in this part examine why the institutional role of altruism is important. Beyond that, we will see why the two other sectors of modern western economies, the governmental sector on the one hand and the private for-profit sector on the other, do not provide adequate institutional vehicles for altruism. This discussion is a critical foundation for section V, in which we examine the policy bases for granting altruistic nonprofits favorable tax treatment.

A. General Supply-Side Phenomena

To understand the importance of altruistic institutions, it is necessary to look at two of their supply-side aspects in some detail.

1. Altruistic Provision of Capital

Hansmann's CARE example is a useful starting place for exploring the altruistic supply of capital. Consider more closely the components of what the altruistic purchaser from CARE is really paying for. As Hansmann points out:

¹⁸⁸ For more ambitious efforts along these lines, see E. JAMES & S. ROSE-ACKERMAN, *supra* note 8, at 25-26; ALTRUISM, MORALITY AND ECONOMIC THEORY Part III (E. Phelps ed. 1975); Amos, *Empirical Analysis of Motivations Underlying Individual Contributions to Charity*, 10 ATLANTIC ECON. J. 45, 45-47; Young, *supra* note 144.

All nonprofit organizations, just like profit-seeking organizations, ultimately must cover the full economic costs of all resources they consume, including both the cost of labor and all other variable inputs and a reasonable return on any capital employed in their activities. There is no magic by which a nonprofit can produce a service at a lower cost than can a for-profit firm.¹⁸⁹

The disaster relief industry is no exception. Transporting foodstuffs overseas certainly requires the use of a fair amount of capital in the form of ships and warehouses, whether these are owned by the nonprofit relief organization itself or by for-profit firms that perform discrete parts of the delivery process on a contractual basis. As Hansmann explains, "[c]apital, like these other factors of production [labor and supplies], is necessary to produce the organization's services, and must be paid for *in the absence of sufficiently generous gifts of capital*."¹⁹⁰

The contract failure theory does not deal with donated capital or with those who provide it. That theory, by Hansmann's own description, is essentially a demand-side account, an explanation of why purchasers of certain goods and services prefer to buy from nonprofits. We have already seen that CARE's provision of goods can be viewed from the supply side by comparing CARE's donors to free suppliers of the variable inputs of production and CARE's recipients to purchasers to whom production is allocated on the basis of need rather than ability to pay. The founding of CARE is even more readily re-characterized in supply-side terms; the more appropriate comparison of CARE's initial funders is not to consumers of shipping services, but to Aristotle Onassis. In Hansmann's demand-side characterization, what the prospective customers of both for-profit and nonprofit carriers are considering is a purchase. Viewed from the supply-side, by contrast, CARE's initial funders, like the Greek Tycoon, are considering an investment. But what a different kind of investment it is. Putting complex issues of psychology aside again,¹⁹¹ the available evidence suggests that Onassis

¹⁸⁹ Hansmann, *supra* note 17, at 880.

¹⁹⁰ Hansmann, *supra* note 129, at 564 (emphasis added). This point was well put in a dissenting opinion in *Utah County*: "A for-profit hospital, unlike a nonprofit hospital, must necessarily price its services to make a profit on its investment if it is to stay in business." *Utah County v. Intermountain Health Care, Inc.*, 709 P.2d 265, 285 (Utah 1985) (Stewart, J., dissenting).

¹⁹¹ For a fuller account—or a less curt dismissal—of issues of mental states and motivation, see *supra* notes 78–90 and accompanying text.

invested his capital where he thought (apparently with a fair degree of accuracy) it would pay him the highest monetary return. CARE's funders "invest" in a shipping concern that, as a matter of law, can pay no dividends whatsoever. We cannot, as we have noted before, be sure what their subjective motives are, much less whether they are wholly selfless. But we can be sure that they are not going to receive a market return on their investment,¹⁹² which thus manifests at least weak altruism. This altruism enables firms with donated capital to work a kind of magic; they can produce a given good or service more cheaply than an equally efficient for-profit firm because they can avoid the cost of one factor of production, capital.¹⁹³

2. Integration

The case of CARE also provides insights into another supply-side phenomenon that Hansmann's contract failure theory does not

¹⁹² As the Virginia Supreme Court noted in connection with gifts to nonprofit hospitals: "The citizens who contributed to the hospitals can never get a return in money from their contributions. The charters of the corporations do not permit it, and the donors do not expect it." *City of Richmond v. Richmond Memorial Hosp.*, 202 Va. 86, 91, 116 S.E.2d 79, 82 (1960).

¹⁹³ It is thus possible and, for some analytic purposes, useful, to distinguish between, on the one hand, those who "purchase" particular goods and services for others from organizations like CARE and the Red Cross and, on the other, those who provide free capital to such organizations. The distinction may, indeed, have practical importance to the organization in its fund-raising activities. See Ellman, *supra* note 33, at 1014 n.37. Some contributors may prefer to pay for the delivery of food rather than for the capital improvements necessary to get the food delivered, and thus may be especially responsive to an appeal that indicates how much food a particular contribution will provide. See Hansmann, *supra* note 17, at 846 n.40.

Some donations to colleges are for "annual funds" that cover current expenses; others are made in explicit response to capital fund drives of the school or are earmarked for specific capital improvements by the donor. Some contributions to religious membership organizations are designated for feeding the hungry; others are expressly for fellowship halls and activity busses, stained glass windows and air conditioning units. See Bittker & Rahdert, *supra* note 90, at 313-14 (comparing the Church of Gospel, which supports mendicant missionaries, with the Church of the Adoration, which underwrites basilicas and reliquaries).

We should be careful, however, not to make too much of the dichotomy between altruistic "purchasers" and altruistic "investors." Many coins in the collection plate and many checks to the alumni office are for no designated purpose. Rather, donors make such donations with the implicit expectation that the donee organization will use them as it sees fit for its announced purposes. Some relief organizations—Save the Children, for example—indicate in their promotional material that contributions go primarily to provide infrastructure and community development rather than short-term relief. Endowed chairs and scholarships are in some ways hybrids, analogous to long term investments with earnings committed, respectively, to covering current expenses and to purchasing current output. The critical point is that both altruistic "purchasers" and altruistic "investors" are donors; their common altruism lies in the fact that they are making a payment to an organization for the benefit of third parties.

address, the need of nonprofit organizations' founders to integrate both horizontally and vertically. In describing why those who wish to provide disaster relief would rather patronize a nonprofit firm than a for-profit, Hansmann ignores a logically prior question: why does each of them not simply put together a private relief expedition? The fairly obvious answer is that the costs would be prohibitively high for many prospective donors acting individually. That raises the more interesting question of how these costs can be lowered. At least a partial answer is horizontal integration. The aggregate costs of a joint effort will predictably be far less than the sum of the costs of individual efforts, for several reasons. Fixed costs—locating the needy foreigners, procuring any necessary export documents, and researching the relative merits of competing shipping lines, for example—can be shared. In addition, pooling resources may make economies of scale obtainable. One secretary, for example, could make the same arrangements for a large shipment of rice by many donors as for a small shipment by a few, and for-profit carriers may well offer more favorable rates per bushel than per bowl.

Altruistic entrepreneurs may find vertical integration advantageous as well, just as for-profit entrepreneurs do. The controllers of CARE, for example, may find not only that they can ship a larger volume at a lower per unit cost, but also that they can save by owning and operating their own cargo vessels rather than contracting with for-profit shippers. Presumably contract failure of the kind Hansmann describes for CARE's potential donors is not a significant factor in that decision. CARE can have its agents in the port of disembarkation to ensure that the goods are not only delivered, but also delivered "as, when, and where specified."¹⁹⁴ The decision, rather, will turn on whether CARE has the necessary capital and whether it can operate ships more cost-effectively than it can contract out for that service. The latter would depend on the relative cost of CARE's operating the ships and the alternative investments available for CARE's capital. It would make little economic sense, for example, for CARE to operate its own ships if it could invest the same capital in government bonds and purchase a higher volume of equal quality shipping services from for-profit firms, which would be the case if for-profit firms were in fact more efficient.¹⁹⁵

¹⁹⁴ Hansmann, *supra* note 17, at 847.

¹⁹⁵ This assumes, of course, that CARE is in fact devoted to producing the greatest amount of relief service at the least cost. It is by no means certain, as the behavior theorists

To return to an earlier point, similar considerations might lead CARE to consider partial horizontal integration—jointly owning and operating a transport ship with Save the Children, for example.¹⁹⁶

B. *The Need for Distinct Vehicles for Altruistic Investment*

We have thus seen that altruistic investors may have economically sound reasons for seeking to integrate their activities on behalf of others. To be cost-effective, altruism sometimes needs an institutional form. We shall now consider whether it needs a distinct form or whether for-profit firms on the one hand or government on the other provides an adequate institutional vehicle for individual altruism.

1. The Problem with For-Profit Firms

In section III, we saw that nonprofit and for-profit firms often provide the same kinds of goods and services. In this section, we have seen that all firms, whether nonprofit or for-profit, must cover

point out, that this is in fact how nonprofits invariably operate. See sources cited in note 8, *supra*. Thus, for example, if CARE's principals were motivated by the empire-building aspirations that Young has identified, see Young, *supra* note 144, at 167, 181, they might invest in tangible assets like ships even if vertical integration were not a cost-effective measure judged by the criterion of output maximization.

¹⁹⁶ In a related vein, Michael Krashinsky emphasizes that both nonprofit and for-profit firms are a response to transaction costs associated with uncertainty. He notes that "[i]n simple microeconomic theory, there are no transaction costs and, as a result, no need for any organizations." In that frictionless world, contractual devices suffice to bring factors of production together. But:

Of course, in an uncertain world, continual contracting and assembling of factors is expensive. Uncertainty makes contracts expensive by requiring a provision for complex contingencies and by opening the way for opportunistic behavior when unanticipated contingencies occur. . . . [V]ertical integration may then become an attractive. In other words, transaction costs are significant and give rise to for-profit firms as way to reduce those costs.

Krashinsky, *supra* note 60, at 115 (citation omitted). These costs, according to Krashinsky, are primarily among factors of production. He criticizes Hansmann and other market failure theorists of nonprofits for describing the transaction costs that nonprofits characteristically address—transaction costs between producers and consumers, and among consumers—as "unusual and requir[ing] special treatment." *Id.* at 115. He himself, however, seems to agree that these latter kinds of transaction costs are distinguishable from those that typically give rise to for-profit firms, and he offers no reason why they do not warrant separate, if not "special," treatment.

The point is that, quite aside from the role Hansmann shows nonprofit firms play in addressing distinct demand side problems between producers and purchasers, such firms also have a critical role in the cost-effective provision of goods and services altruistically.

the cost of capital as a factor of production and that both for-profit and nonprofit firms are frequently more efficient means of organizing production than simple contractual devices among individuals. These similarities raise a question: Could for-profit firms serve as an adequate vehicle for altruistic investment?¹⁹⁷

Before we attempt to answer this question, we must first examine what such investments would be designed to achieve. Unlike ordinary investors,¹⁹⁸ altruistic investors are not concerned with receiving the maximum return on their capital themselves. Rather, an altruistic investor wants to provide a firm with cost-free capital in the expectation that the firm will pass this cost savings on to the consumers of its output in the form of lower prices or higher quality at the same price. Thus, for example, our altruistic alumni donor wanted to put liberal education within the budgets of the next generation of students. The question is whether altruistic investments in for-profits can be structured to ensure that this pass-through occurs. What the altruistic investor needs is an enforceable commitment from the managers of the for-profit firm that they will use the imputed return on her donated capital to subsidize consumption.

In some industries, the feasibility of such an arrangement with for-profit firms may be moot. There will likely be no for-profit entities at all, and little likelihood of creating them, in industries that exhibit the demand-side contract failure that Hansmann describes. Prospective for-profit suppliers of famine relief and listener-sponsored radio simply will not be able to give ordinary donors the necessary assurances as to the ultimate destination of their gifts. The donated dollars such organizations need to cover their variable costs will for that reason go to CARE and to nonprofit broadcasters.

The matter stands somewhat differently, however, in industries affected by Hansmann's third form of contract failure, which results from the sale of complex goods and services. As Hansmann points out, nonprofit organizations that supply such products frequently

¹⁹⁷ Hansmann considers the converse question—under what conditions could nonprofit firms serve as vehicles for ordinary investment?—in Hansmann, *supra* note 129, at 564–67.

¹⁹⁸ "Ordinary investor" is perhaps not the logical term to contrast investors who seek to maximize return to themselves with those who let others use their capital without expectation of personal return. But the terms that better underscore the contrast with altruism—"selfish" and "egoistic," for example—carry too tendentious a connotation of moral disfavor. And "ordinary" does have something positive to recommend it on purely descriptive grounds. Most of us, most of the time, are concerned with investing for our private gain rather than for the good of unrelated others.

have for-profit competitors, presumably because some consumers feel themselves able to evaluate such goods well enough to buy them from for-profits. To reach those who, lacking this confidence, patronize nonprofits, suppliers of cost-free capital would presumably have to operate through nonprofit firms.

But what if the altruistic capital suppliers are indifferent to this characteristic of the consumers they subsidize? They may want to subsidize not just unsophisticated consumers of complex health care services, but all consumers. Beyond that, what if, as in the case of the founders of Presbyterian and Reformed Publishing Company¹⁹⁹ and Orton Ceramics,²⁰⁰ they wish to subsidize the consumption of ordinary consumer goods that anyone can evaluate? Why, in these circumstances, cannot altruistic capital suppliers work through for-profit providers? Any such arrangement, of course, would present monitoring problems similar to those of Hansmann's separation-of-purchaser-from-consumer form of contract failure. Yet these problems are more serious for capital suppliers, for several reasons.

Consider the case of a prospective capital donor to a school. She basically wants to subsidize the students' educations through a one million dollar capital infusion to the institution. Education is essentially a private good, and its quality is relatively easy to monitor, if not by students themselves, then by their parents, high school guidance counselors, and accreditation bodies. The donor's general wish is that students be the actual beneficiaries of her gift, but she is indifferent as to whether the subsidy comes in the form of lowering present costs or increasing quality at the same cost. Indeed, she is even willing to have the money benefit the students fairly indirectly, as by the enhanced reputation the school will acquire if its faculty are encouraged to publish with inducements like bonuses and research leaves. Her only condition is that the subsidy continue in perpetuity; in other words, that the recipient spend only the gift's income, not its principal. In a nonprofit school, of course, this would be a fairly routine—not to say unappreciated—addition to endowment.

If given to a for-profit school, by contrast, this donation would present several problems for the donor. Some of these are common to the kind of donors Hansmann describes in his contract failure account of donative nonprofits; others are peculiar to donors of

¹⁹⁹ *Presbyterian and Reformed Publishing Co. v. Commissioner*, 743 F.2d 148, 151 (3d Cir. 1984).

²⁰⁰ *Edward Orton, Jr., Ceramic Foundation v. Commissioner*, 56 T.C. 147, 149–50 (1971).

capital. Like the donor to CARE, the school donor faces the prospect of having her entire donation siphoned off as additional profits to the donee organization's ordinary investors. The skimming problem for the school donor, however, has an on-going aspect. Not only must she ensure that her donation is not initially skimmed; she must also ensure that each year the real or imputed income from that donation goes to the appropriate recipients.

The solution to the first of these problems seems easier in the case of the school donor. She can minimize the risk that the capital itself will be paid out as increased profits by requiring that it be set aside in a separate account. This, however, only ensures that capital is not skimmed, not that its income is passed on in the form of lower prices or higher product quality. For-profit investors may simply withdraw an equal amount of their own capital and continue delivering the same quality and quantity of education, at the same price. Unless the donor takes steps to prevent this, she will in effect have given the school's ordinary investors an annuity equal to the present value of the return they will make on the capital in its designated use.

There are, of course, steps that can be taken to prevent this, but none of them is entirely satisfactory. The donor could, for example, require that her capital contribution be spent on an addition to the physical plant that she is reasonably certain the for-profit management would not otherwise undertake.²⁰¹ This would prevent ordinary investors from withdrawing an equal amount of their own capital. But it would still not ensure that the return on her capital would go to students rather than to ordinary investors, who might simply charge the same price for a service that they can now provide at a lower cost. Moreover, expansion of the physical plant may not be what the donor believes the institution needs to undertake, and it might in fact be inefficient as well. In economic parlance, marginal returns on adding more plant at the existing level of other factors of production may have diminished to the point at which each dollar of additional plant is now producing less than an additional dollar of output.

Alternatively, the donor could require that income from the endowment be spent in a way that necessarily subsidizes consumption, as by providing scholarships. In this way, the capital gift to the

²⁰¹ See Ellman, *supra* note 33, at 1014 n.37.

school in effect becomes a series of ordinary gifts to particular students. Instead of buying output for a third party from time to time, as the ordinary donor to CARE does, the capital donor who establishes a scholarship fund will have set up a mechanism to do the same thing automatically and perpetually. As Hansmann suggests in connection with the CARE case, this will work as long as the donor (or her agents) can monitor the delivery of the good or service to the third party at reasonable cost. In the case of free tuition to students at domestic institutions, the monitoring costs should not be unduly high.²⁰²

But even so, this may be a decidedly second-best solution. If the school already provides some scholarships, perhaps to enhance its reputation by "buying" capable but indigent students, the donor's funds may simply displace funds that were already being spent on free education, resulting in no increased output.²⁰³ The donor could perhaps solve this problem by getting a commitment from the institution to maintain its own funding at prior levels.²⁰⁴ But even if this worked, a more fundamental problem would remain. What the donor primarily wants may be a flexible usufructuary gift to be applied for the benefit of students in the way that those best suited to know student needs at any particular time think best. What is more, the donor may think that those with the best insights into student needs are those who govern the school. A donor of this mind needs to be able to make the kind of general endowment gift that we have seen would create severe monitoring problems if the donee organization were a for-profit firm.

I have chosen the school example because education is an industry which provides essentially private goods and yet one in which general purpose donative capital financing—endowments—is common. Hospitals provide a similar example, though in that industry endowments now play a less significant role than formerly. Analytically similar problems would arise in any industry in which for-profit firms supply a good or service that donors would like to

²⁰² Hansmann has shown that subsidies through for-profit firms present fewer problems where the subsidizer can deal directly with the ultimate recipients, as by providing them with redeemable coupons for the good or service subsidized. Under such a voucher system, the donees themselves can monitor delivery. Hansmann, *supra* note 17, at 848. This does, of course, impose on donors the cost of locating and dealing with the ultimate donees.

²⁰³ Ellman, *supra* note 33, at 1013–14.

²⁰⁴ See *infra* notes 233–34 and accompanying text for a further consideration of this possibility in connection with private foundations.

subsidize with capital contributions. As we saw in connection with our discussion of Type 7 organizations, this could in principle include any capital-intense industry.²⁰⁵

Thus, if altruistic individuals want to obtain the advantages of integration that we discussed above, they will find that for-profit firms do not provide an adequate institutional vehicle. Moreover—and significantly, for our purposes—for-profit firms will pose problems not only in industries affected by the kinds of market failure Hansmann describes, but in all industries, at least for general purpose capital grants.

2. The Problem with Government

The government is a fairly obvious alternative to private, for-profit suppliers in the case of at least one of the three primary forms of contract failure Hansmann identifies, the problem of public goods, goods that tend to be under-supplied in the market because their producers cannot prevent those who do not pay for them from enjoying them. Lighthouses and national defense are classic examples. Government, unlike for-profit firms, has a means of addressing the free-rider phenomenon—levying taxes to pay for collective-consumption goods. Indeed, this is a widely accepted role of government.²⁰⁶ Moreover, government's acceptable role now includes not only this efficiency-justified job, but also at least a measure of wealth redistribution as well. And modern governments supply a number of goods and services that have little or no public good, or collective consumption, component. Is government, then, an adequate alternative to nonprofit organizations as an institutional outlet for altruistic supply?

Part of the answer lies in how the goods to be provided by government are chosen. Burton Weisbrod has developed a theory of when government will supply public goods, and to what extent.²⁰⁷

²⁰⁵ See *supra* note 150 and accompanying text for a discussion of the effect of capital contributions on returns.

²⁰⁶ See P. SAMUELSON AND W. NORDHAUS, *ECONOMICS* 712–15 (12th ed. 1985).

²⁰⁷ Weisbrod, *Toward a Theory of the Voluntary Nonprofit Sector in a Three-Sector Economy*, in *THE ECONOMICS OF NONPROFIT INSTITUTIONS*, *supra* note 33, at 21.

Following Weisbrod, I draw no distinction between two distinct forms of government provision: actual production by the government itself and government purchase from a for-profit producer. Weisbrod, *supra*, at 23. For the government failure theory, the critical element of both these approaches to government provision is that the government finances the production. *Id.*

For an explanation of why Weisbrod's theory is only a partial answer to the question posed in the text, see *infra* notes 211–19 and accompanying text.

In a democratic polity, the decision-making process will be by majority vote. Thus "[g]overnment will supply a quantity and quality of any commodity that is determined by a political voting process."²⁰⁸ If this supply is financed by conventional taxes, voters will probably be unable to equate the amount of tax they pay with the amount of benefit they derive from additional increments of governmentally-provided goods.²⁰⁹ Accordingly, the result of their collective decision-making will be to provide public goods at the level of quality and quantity that satisfies the demands of the median voter.²¹⁰ Voters who prefer different levels, whether higher or lower, will thus be left dissatisfied with governmental provision of public goods.²¹¹

These dissatisfied voters face several options, the most feasible of which may be to form a nonprofit firm.²¹² Such suppliers will not be immune to the problems of producing public goods, in particular the problem of free-riders. But, in the absence of a

²⁰⁸ Weisbrod, *supra* note 207, at 23.

²⁰⁹ Weisbrod's model makes this probability an explicit assumption, *id.* at 23, and notes that it will not hold true in at least one reasonably likely scenario, that of vote trading or logrolling. See also Hansmann, *Economic Theories*, *supra* note 5, at 29 n.4 (pointing out the possibility of logrolling and similar devices, but suggesting it is unlikely to work well in the case of "extremely intense or idiosyncratic demands for public goods."). He argues, however, that the practical effect of such behavior is reduced by "the combination of information costs, strategic behavior (transaction costs) and, in most instances, legal prohibition (against 'selling' votes)." Weisbrod, *supra* note 207, at 23. For an argument that it is these and other transaction costs that best account for "government failure," see Krashinsky, *supra* note 60, at 125.

²¹⁰ Weisbrod explicitly indicates that the quantity demanded by the median voter "can be zero." Weisbrod, *supra* note 207, at 30. It is thus misleading to say, as one of his critics has, that he "assumes agreement about the nature of the good and that the disagreement [among voters] is quantitative—how much of it people are willing to pay for in taxation." J. DOUGLAS, *supra* note 9, at 129. This is an accurate reading of Weisbrod only if the quantitative disagreement is meant to include no provision at all. This does not seem to be Douglas's point, for he goes on to suggest that Weisbrod's model cannot account for the emergence in the nineteenth century of redistributionist relief organizations when a majority of voters did not favor government relief programs. *Id.*

²¹¹ Weisbrod, *supra* note 207, at 23–24.

²¹² They can emigrate, *id.* at 27, but that is a dramatically costly alternative. They can organize production by a lower-level governmental unit, as is frequently done with parks and libraries. But this may be relatively expensive, especially if the lower-level unit is not already in place, and in any case some voters' demands may still be unmet. They can seek substitute goods from private suppliers, but such substitutes may be either poor substitutes for the public good or prohibitively expensive. *Id.* at 27–29.

As Weisbrod is careful to note, the sequence in which these alternatives is presented is merely for expositional convenience; he does not mean to suggest that this is in fact the order in which alternative sources of *supramedian* levels of public goods are sought. *Id.* at 26–27, 30. According to Weisbrod, it is more likely that "all of these organizational forms for satisfying consumer demands are simultaneously operative." *Id.* at 27.

- supplier better able to address those problems, nonprofit suppliers may offer the best available alternative.²¹³

Weisbrod's government failure theory is stated in demand-side terms; those who seek more of a public good than the median voter turn to nonprofit suppliers. It is important to note, however, that the financing of these nonprofit suppliers will be by contributions. As we have seen, even those who "pay" for public goods in an amount equal to the benefit they expect to receive are exhibiting weak altruism because they can enjoy the same benefit without paying. This fact returns us to the supply side. Weisbrod does not directly address why those willing to pay for public goods beyond the level supplied by government do not do so by contributing to the government rather than to nonprofit firms. Weisbrod's theory tells us why government does not finance more of a particular public good than the median voter wants, not why those who are willing voluntarily to finance more do not choose to do so through governmental entities.²¹⁴

Part of the reason may be chronological. As Weisbrod points out:

It is likely . . . that the governmental sector will *not* be the first to respond to consumer demand for collective goods. The reason is that demands by all consumers do not generally develop simultaneously, and so the political decision will at first determine a zero level of governmental provision, leading undersatisfied demanders to nongovernmental markets.²¹⁵

As evidence of this, he cites the priority in sixteenth century England of nonprofit suppliers in virtually the entire range of non-military public goods now deemed to be governmental responsibilities.²¹⁶ Sometimes this threshold of majority demand may never be crossed, government will not produce any of a particular good or service, and subsidized supply will perforce be by nonprofits. But when the threshold is crossed, is there any reason for nonprofit suppliers to exist alongside parallel governmental suppliers?

One explanation of private nonprofit supply looks to several inherent characteristics of government as an institution. James

²¹³ *Id.* at 30.

²¹⁴ Sometimes, of course, they do contribute to governmental entities, as the cases of public television and public universities indicate.

²¹⁵ Weisbrod, *supra* note 207, at 50 (emphasis in original).

²¹⁶ *Id.* at 33-34.

Douglas has identified what he calls "categorical constraints" on governmental provision of goods and services, constraints that, in his view, derive from legal and political pressures on governmental agencies to provide goods and services uniformly within their jurisdictions. This tends to produce not only standardized provision, but also bureaucratic overlays to ensure equality of treatment to similarly situated recipients.²¹⁷ Private nonprofit suppliers, by contrast, offer greater opportunities for diversity, experimentation, and informality. Whether or not these asserted advantages are real, it seems highly probable that some altruistic suppliers will think they are, and will accordingly choose to contribute capital to nonprofit organizations even when governmental organizations providing similar goods and services are available.²¹⁸ Beyond that, some altruistic suppliers may prefer non-governmental suppliers less out of a confidence in their ability to overcome any inherent problems in government provision than out of a belief that limiting the role of government is itself a desirable goal.²¹⁹ As we have seen, this perspective became national policy under President Reagan.

Weisbrod's government failure theory of the role of nonprofits admittedly sheds no direct light on the role of government as a supplier of ordinary consumer goods, as opposed to public or collective consumption goods, although he does point out that governments produce both kinds of goods.²²⁰ It would be consistent with his theory, however, to maintain that government subsidizes private goods at the level demanded by the median voter, leaving some demand for subsidized supply unmet. Those who attempt to meet that additional demand by altruistic supply would have many of the same reasons for preferring nonprofit outlets as those who choose to contribute to the supply of public goods. And, as a practical matter, they are likely to find fewer existing government suppliers in place even if they were willing to operate through them.

²¹⁷ Douglas, *Political Theories of Nonprofit Organization*, in *THE NONPROFIT SECTOR*, *supra* note 2, at 43, 46-50; J. DOUGLAS, *supra* note 9, at 114-41; *see also* Krashinsky, *supra* note 60, at 125 (formation of nonprofits may have less to do with government's unwillingness to respond to demands beyond those of the median voter than with various transaction costs of government provision).

²¹⁸ Others have identified this and related advantages of nonprofit over governmental provision. *See, e.g.*, Hansmann, *supra* note 17, at 895; E. JAMES & S. ROSE-ACKERMAN, *supra* note 8, at 69-77.

²¹⁹ For a classic statement of this perspective, with a call for the private nonprofit sector to challenge and replace the state as the ensurer of public welfare, on the strength of Goldwater political ideology and upbeat anecdotes, *see* R. CORNUELLE, *RECLAIMING THE AMERICAN DREAM* (1965).

²²⁰ Weisbrod, *supra* note 207, at 30-31.

C. *Private Foundations*

In the first part of this section, we saw some compelling reasons for altruists, particularly altruistic suppliers of capital, to give organizational form to their efforts. In the second part of this section, we saw why neither for-profit firms nor government provide entirely adequate institutional forms for this purpose. To avail themselves of the advantages of horizontal and vertical integration, altruists need their own special, separate organizations. In this subsection we will look at one form of altruistic organization, the private foundation, that performs a role distinct from the altruistic organizations we have examined thus far.

Hansmann's four-part typology of nonprofit organizations and his contract failure theory of why they arise focus primarily on "operating" nonprofits, those that produce goods and services. He explicitly leaves to one side private charitable foundations, which he describes as being "for the most part . . . philanthropic intermediaries that produce no goods and services of their own."²²¹ This subordination of foundations is entirely appropriate in an account that asks why certain goods and services are produced by nonprofits rather than by for-profits or, more precisely, why purchasers prefer to buy certain products from nonprofits rather than from for-profits. But in an account that focuses on the role of altruism in nonprofits and that looks at least preliminarily at the role of altruistic nonprofits on the supply side, private foundations must figure more prominently. We will look first at Hansmann's treatment of private foundations, then at private foundations as supply-side phenomena, as we did with operating organizations in the previous part of this section.

1. The Contract Failure Account of Private Foundations

Hansmann's brief account of private foundations subsumes them under the general terms of contract failure as applied to donative nonprofits like CARE, organizations that provide subsidized services to recipients with whom the donor is not in direct contact. According to Hansmann:

If a wealthy individual wishes to turn over part of his fortune to a relatively autonomous organization that will itself choose the ultimate recipients of his largesse, he

²²¹ Hansmann, *supra* note 17, at 837 n.15.

obviously will want to impose some form of nondistribution constraint upon that organization.²²²

This brief account overlooks several salient differences between the typical private foundation and organizations like CARE, differences that make the contract failure theory a rather procrustean fit for private foundations. On the other hand, a closer look at private foundations shows them to be compatible, if occasionally eccentric, bedfellows for the operating nonprofits we have already covered under the supply-side altruistic account.

Hansmann is quite right in pointing out that private foundations are charitable intermediaries, rather than primary producers of goods or services like operating nonprofits.²²³ He fails to note,

²²² *Id.* at 848 n.41.

²²³ Without qualification, the term "private foundation" covers more ground than I intend to in this section. For my purposes, and in ordinary parlance, a private foundation is a charitable organization with two distinctive characteristics. First, it is funded and controlled primarily by a single donor, family, or company. B. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* 429 (1987); Council on Foundations, *Private Foundations and the 1969 Tax Reform Act*, in 3 *FILER COMMISSION PAPERS*, *supra* note 3, at 1557. Second, it is a charitable intermediary; its primary activity is not the active conduct of a charitable program, but the financing of the charitable programs of other organizations through grants or loans. The complex definition of private foundation by exclusion in section 509(a) of the I.R.C. is designed to cover these organizations, but is probably both over- and under-inclusive.

Private foundations in the lay sense in which I use the term are to be distinguished from three related kinds of altruistic nonprofits: company foundations, community foundations, and private operating foundations. Private operating foundations may be supported and controlled by a single donor, but they must engage in the active conduct of a charitable program. To meet the statutory definition of private operating foundation, they must expend 85% of their income in the conduct of such a program. I.R.C. § 4942(j)(3) (1988); Treas. Reg. § 53.4942(b)-1(c) (as amended in 1983); see Ylvisaker, *Foundations and Nonprofit Organizations*, in *THE NONPROFIT SECTOR*, *supra* note 2, at 360. They generally exhibit the first distinctive feature of private foundations, private control and support, but not the second, extensive grant-making. Under the federal income tax laws they are treated for most, but not all, purposes like grant-making private foundations. The most significant difference is that they are not subject to the minimum distribution requirement of section 4942 of the I.R.C.

Community foundations, by contrast, exhibit the second characteristic of private foundations but not the first. They are generally grant-making organizations, but "are characterized by multiple sources of funding, boards of directors selected to reflect public interests and concerns of their communities, and a local or regional focus in their giving." Council on Foundations, *supra*, at 1560. On account of the more public flavor of their focus, support, and governance, they are classified as public charities for federal tax purposes and are thus free of the more rigorous regime applicable to private foundations. *Id.*; see also Ylvisaker, *supra*, at 361 (describing basic characteristics and noting recent proliferation of community foundations); cf. B. HOPKINS, *supra*, at 447-48 (community foundations are designed primarily to attract large donations from a small number of donors, though they may qualify as public charities if they attract sufficient public support).

Company foundations, finally, are private foundations in the lay sense of the term; they

however, that this intermediary role gives rise to problems of contract failure at two distinct points: first, between the initial donor and the private foundation; and second, between the private foundation and its own grantees. The response to the risk of contract failure differs at each juncture, and the response at both junctures differs from that in the other contexts Hansmann describes.

Between the donor and the foundation, contract failure of any kind is unlikely to be a serious problem during the donor's lifetime. For one thing, a private foundation is rarely "relatively autonomous" of the donor. More typically, it is the donor's charitable alter ego, with its long-term aims set by her and implemented by her hand-picked lieutenants.²²⁴ For another, the stake of the private

exhibit both of the features identified above and are subject to the full range of rigorous private foundation regulation under the Internal Revenue Code. It is their historical development and their governance that distinguish company foundations from the classic individual or family foundation. The notion that corporations themselves, as opposed to their shareholders as individuals, could engage in philanthropy developed relatively long after the theory of private foundations as a vehicle for individual philanthropy. Ylvisaker, *supra*, at 375. Furthermore, the trustees of corporate foundations, even when not identical with corporate management, nevertheless operate within the corporate framework, "ultimately having to satisfy the shareholders that what they do is in the best interests of the corporation." *Id.* at 361, 363; see also Baker & Shillingburg, *Corporate Charitable Contributions*, in 3 *FILER COMMISSION PAPERS*, *supra* note 3, at 1853, 1862-63. This is probably in part a function of the fact that most company foundations lack large endowments and depend on annual distributions from their corporate parent, Council on Foundations, *supra*, at 1561, another feature that distinguishes them from the classic private foundation. Cf. Baker & Shillingburg, *supra*, at 1859 ("By using a foundation, the company can contribute in profit years and build up a small corpus which is available to supplement smaller contributions in lean years."); Useem, *Corporate Philanthropy*, in *THE NONPROFIT SECTOR*, *supra* note 2, at 340, 345 (use of company foundation permits a company not only to engage in a degree of counter-cyclical giving, but also "to shield a portion of its gifts from internal management pressures . . .").

²²⁴ Thus, according to W. NIELSEN, *THE BIG FOUNDATIONS* 279 (1972):

Among the big foundations there are only a few cases where a donor's resources have been transferred to an independent philanthropic institution not heavily influenced by his descendants or interconnected with his company or companies. . . . The typical situation is one in which the donor has children as well as other relatives, and in which he has been the dominant shareholder of one or at most a few enterprises, the control of which upon his death passes to his foundation or to his family or to a combination of both. This results in a triple interlinkage which is both intimate and enduring. As to the choice of the foundation's governing board, Nielsen discovered that founders usually restrict themselves to family members and close business or personal acquaintances. Aside from being personally known by the donor, the primary criterion is reliability in maintaining family control.

Id. at 314.

The Tax Reform Act of 1969 struck hard at the links between foundations and their founders' corporations, see I.R.C. § 4943 (1988), but left links with their families essentially intact. See *infra* notes 271-74 and accompanying text for further discussion of private foundations and the 1969 Act.

foundation founder, unlike that of the small scale donor to CARE and other operating nonprofits, is usually large enough to warrant a substantial investment of additional resources in scrutinizing her creature's activities. The challenge faced by the donor to a private foundation is not, as Hansmann suggests, finding a trustworthy organization that will dispense the donor's bounty to charitable objects of the organization's choice and not to its autonomous controllers. Rather, the donor's challenge is to create and control an organization that is the institutional embodiment of the donor's own altruistic impulses.

Even though the founder of a private foundation is thus unlikely to experience contract failure between herself and her organization, she still faces problems of contract failure on another front. Not only must the private foundation founder assure that her creature does her charitable will; the foundation itself, as instrument of that will, needs some means of assuring that its grantees in turn toe the line. The founder of a private foundation can take small comfort in the fact that the managers of her organization do not siphon off her beneficence in illicit dividends or self-dealing transactions if they make grants to other organizations that do. The grant making methods of private foundations offer a solution to the problem of contract monitoring that tends to confirm the gravity of that problem as Hansmann describes it for small scale individual donors.

Implicit in Hansmann's contract failure account of relief organizations like CARE is the possibility that, but for excessively high monitoring costs, individual donors might be able to enter into contracts with for-profit firms to supply services like disaster relief to third parties.²²⁵ Moreover, in his account of why donors to listener-sponsored radio prefer nonprofit suppliers, Hansmann explicitly explores the possibility of contractual arrangements with for-profits. He finds that such contracts could provide essentially the same protections to donors as nonprofit status, but at a prohibitively high cost in individual negotiation and enforcement efforts.²²⁶ Thus, in his view, "[t]he advantage of the nonprofit form . . . is that it economizes on contracting and enforcement."²²⁷ The nonprofit form is in effect a common contract, of which the government acts as a single centralized monitor.²²⁸

²²⁵ Hansmann, *supra* note 17, at 847.

²²⁶ *Id.* at 853.

²²⁷ *Id.*

²²⁸ *Id.*

Unlike small-scale individual donors, private foundations may not find the costs of negotiating and monitoring individual contracts with for-profit suppliers prohibitively expensive. Rather, their size and expertise may enable them to achieve economies of scale in precisely these functions. These potential economies of scale for private foundations may thus be an exception that proves the general rule articulated by Hansmann, that tailoring of arrangements with donees is prohibitively costly.²²⁹

And these advantages may help private foundations in dealing with nonprofit grantees as well. The nondistribution constraint ensures at most that donated funds will not be diverted into private pockets. It does not guarantee that the funds will not be indirectly used for a legitimate purpose of the donee organization other than that which the donor intended. If an organization provides two or more goods or services—disaster relief and community development, for example—it is difficult for donors who designate one program to ensure that their contribution results in a net increase in the organization's expenditures for that program. A fifty dollar contribution earmarked for famine relief may simply allow the relief organization to divert fifty of the dollars it would otherwise have used for that purpose to an irrigation project. Thus, contributions earmarked for one purpose, even if scrupulously set aside, may simply free the organization to use an equivalent amount of its own funds for other purposes.²³⁰

A donor can avoid this problem by giving to an organization that has a single purpose,²³¹ but even then donated funds may be mismanaged or used inefficiently. Choosing organizations with like-

²²⁹ Hansmann may exaggerate these costs somewhat. The context in which he discusses contractual alternatives to the nondistribution constraint, the provision of public goods like listener-sponsored radio, is perhaps a worst-case scenario. As he points out, when the good or service to be subsidized is undifferentiated from products that the for-profit organization is already supplying with other income, any contractual alternative to the distribution constraint will have to involve a cap on the organization's total distributions to its owners. Hansmann, *supra* note 17, at 851–52. This kind of comprehensive scrutiny may not be necessary, however, when incremental units of output are more easily traced to particular increases of input, as would be the case when the output is a private good. A donor may not know whether his dollar paid to a lighthouse operator is being used to increase output unless he looks at the entire income and expenditure statement, but the underwriter of hospital care or discrete research projects need only look at the donee organization's grant receipts and expenditures.

²³⁰ Ellman illustrates the same phenomenon with an example that hits closer to home—donated dollars intended for undergraduate aid in effect flowing into research on nonprofits. Ellman, *supra* note 33, at 1013–14.

²³¹ *Id.* at 1014 n.37.

minded management also helps, but at the cost of either careful screening in the case of entrepreneurial or donor participation in governance in the case of mutuals.²³² In addressing the fungibility of dollars problem, small-scale donors encounter a kind of contract failure in the nonprofit realm itself; negotiating and enforcing an agreement with donee organizations as to specific uses of funds may be prohibitively costly.

Larger private foundations, by contrast, may be able to overcome these cost barriers by achieving economies of scale in grant-writing and oversight.²³³ This kind of monitoring almost certainly lets them see how cost-effectively the grantee operates, how much bang it gets with a given amount of granted bucks. Beyond that, such monitoring may also permit foundations to ensure that particular grants effect real increases in the grantee's expenditures for targeted programs, as, for example, by tracking compliance with requirements that grantees increase their pre-grant levels of expenditure for those programs in the amount of the grant.²³⁴

2. Private Foundations and the Altruistic Supply of Capital

The contract failure theory thus ignores the fact that private foundations present and address the contract failure problem at two analytically and practically distinct points, the founder's grant to the organization and the organization's subsequent grants to

²³² *Id.* at 1035.

²³³ Ellman points out that both private foundation and government grants often include restrictions similar to the contractual alternatives to the nondistribution constraint that Hansmann considers. Ellman, *supra* note 33, at 1016; see Hansmann, *supra* note 17, at 851-53.

²³⁴ Federal tax law has not left private foundations to their own devices in the matter of monitoring grants. Under the Tax Reform Act of 1969, a private foundation is subject to stiff penalty taxes for grants to organizations other than public charities unless the foundation exercises "expenditure responsibility" for the grantee's use of the funds. See I.R.C. § 4945 (1988); Treas. Reg. § 53.4945-5 (as amended in 1973). In broadest outline, these provisions require that private foundations make reasonable efforts and establish adequate procedures (1) to see that grants are spent only for their designated purposes, (2) to obtain documentation from the grantee on grant expenditures, and (3) to report to the I.R.S. on grant expenditure. Treas. Reg. § 53.4945-5(b)(1).

These measures probably work reasonably well to ensure that grantees comply with grants' terms. They do not, however, seem to address the fungibility of dollars problem, since they require monitoring only of the use of the granted money, not the grantee's other resources. The steps the foundation must take to ensure that its grant is used for the specified purposes do not necessarily ensure that the organization's total expenditures for that purpose will increase by the amount of the grant. Instead, as we have seen, the organization may simply reduce its own funds otherwise directed to that purpose by the amount of the grant. Further, in the case of for-profits, the amounts so diverted are available for distribution to the organization's owners as additional profits.

operating organizations. There is, however, a more fundamental reason why Hansmann's contract failure theory is an inadequate account of private foundations. Recall that Hansmann's theory, by his own description, is essentially a demand-side account, an explanation of why purchasers of certain goods and services prefer to buy from nonprofits. We have already seen that the founding of an altruistic operating nonprofit like CARE is essentially a supply-side phenomenon. Those who contribute capital to such an enterprise are in a sense providing it with cost-free capital. The same is true of the founding of a private foundation, with this difference: private foundations are not in the business of producing a particular good or service. Rather, their function is to finance the production of goods and services by others.²³⁵

In that respect, they function as nonprofit banks, sometimes quite literally. Thus, for example, the Internal Revenue Code's restrictions on overly risky investments by private foundations contain an exception for "program related investments." These are investments the primary purpose of which is to accomplish charitable purposes and no significant purpose of which is the production of income or the appreciation of property.²³⁶ A private foundation might make a loan at below market rates to a minority-owned small business in a decaying urban area for encouraging economic development or to a disadvantaged individual for college education.²³⁷

The recipients of these loans, of course, are quite free to borrow money for such projects from for-profit lenders. But the market rate of interest, reflecting the level of risk, is likely to be discouragingly, if not prohibitively, high. This is not to say that in such cases the market has failed;²³⁸ one function of capital markets is to

²³⁵ Defenders of private foundations have frequently noted this financing role. As one sympathetic report put it, "foundations have the particular characteristic of serving as sources of available capital for the private philanthropic sector of our society in all its range and variety." Council on Foundations, *supra* note 223, at 1560; see also Simon, *Charity and Dynasty Under the Federal Tax System*, 5 PROB. LAW. 1 (1978).

²³⁶ I.R.C. § 4944(c) (1988); Treas. Reg. § 53.4944-3(a)(1) (1972).

²³⁷ These illustrations are taken, with some compression, from Treas. Reg. § 53.4944-3(b) (1972) (examples (1) and (9)). For other examples, see B. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* 556 (1987).

²³⁸ Some important instances of private foundation financing do involve elements of market failure. As we have already seen, see *supra* notes 113-14 and accompanying text, Hansmann argues that students are frequently unable to finance their education through loans from for-profit lenders because of the difficulty of using human capital as collateral. Furthermore, many of the goods that will presumably flow from the program related investments described above are essentially aspects of community development, a classic public good.

indicate which investments are excessively risky relative to alternatives. The point to note here is that, even when functioning with theoretical perfection, the for-profit capital market ignores benefits that are of essential concern to altruistic investors, benefits that accrue in any number of ways to persons other than the investors themselves. The most sophisticated analysis of the risk of default on student loans will never reveal that a mind is a terrible thing to waste, for that is a matter not of fact, but of something more like faith.

The more typical mode of private foundation finance, outright grants free of any obligation to repay either principal or interest, can also be compared to banking.²³⁹ In an important sense, however, the banking analogy distorts private foundations' essential role; banks are hardly in the business of giving away money. The more helpful comparison, for purposes of identifying the role of private foundations in the altruistic supply of capital, is to the ordinary investment activities of the wealthy individuals who create private foundations. For our purposes, ordinary investors can be said to be engaged in two essential functions. The first and most obvious we have already seen—they are, by definition, investing capital to produce the highest rate of return.²⁴⁰ Having earned the money, they must then decide what to do with it; a necessary correlate of earning money is the second function of ordinary investors, disposing of it. Basically, they have two choices. They can re-invest the money, adding it to their other capital, or they can spend it. In their philanthropic activities the founders of private foundations perform essentially the same functions. Not surprisingly, then, large-scale philanthropists and ordinary investors face similar needs to integrate their functions and to place those functions in distinct entities.

3. The Advantages of Integration

The advantages of integration that private foundations offer are not essentially different from those that their founders can achieve as individuals with respect to their two parallel functions, earning income and disposing of it. This is especially true with respect to the former function. The wealthy foundation philanthropist, like a well-heeled ordinary investor, will want expert advice on where to get the highest return on investment. Founders of

²³⁹ See Steinberg, *supra* note 61, at 123.

²⁴⁰ See *supra* note 198 and accompanying text for a discussion of ordinary investors.

private foundations usually want their philanthropy to operate in perpetuity, paying out to operating organizations the income from their invested endowment rather than the principal of that endowment.²⁴¹ Both ordinary investors and private foundation founders can buy this kind of advice from others. Or they may find it cost-effective to perform certain investment assessments in-house, rather than by contracting them out to otherwise independent agents. Indeed, private foundations have traditionally exhibited a range of degrees of vertical integration of their investment activities.²⁴²

In performing their second common function, disposing of the ultimate returns of their investments, the foundation philanthropist and the ordinary investor face another common problem—whom they shall benefit, and how. The objects of their bounty will, as we have seen, lie along a spectrum that runs from the donors themselves, through family and personal acquaintances, past third cousins and anonymous compatriots, to neighbors in the most Samaritan sense. At whatever point on the spectrum they decide to spend, the wealthy enjoy a substantial degree of discretion, discretion that need not involve any more expert consultation in altruistic matters than in others. Decisions as to expenditure of philanthropic dollars, every bit as much as those for personal consumption, can be based on personal preference and predilection and can be ad hoc and idiosyncratic, if not eccentric. Such, indeed, was the character of traditional philanthropy.

By the end of the nineteenth century, however, attitudes toward the adequacy of conventional modes of philanthropy had begun to change. Even among the wealthy themselves, faith in the symptomatic and palliative remedies offered by traditional philanthropy gave way in the face of the dislocations associated with America's rapid urbanization and industrialization. Concerned about these dislocations and appalled by the prospect of socialism, the more philanthropic—or frightened—of the great industrialists cast about for a private sector alternative to extensive governmental interven-

²⁴¹ According to John Simon, "[w]ith few exceptions, foundations do not receive their funds as true legal endowments—that is, funds burdened by a restriction on expenditure of capital—but many foundations (and most big ones) treat their funds that way." Simon, *The Tax Treatment of Nonprofit Organizations*, in *THE NONPROFIT SECTOR*, *supra* note 2, at 67, 80 n.24. Given the extensive degree of control generally maintained by donors during their lives, it seems safe to assume that this is how they want things.

²⁴² See Ylvisaker, *supra* note 223, at 364 (until recent concerns about ethical investing and program-related investments, investment decisions were "handled conventionally by designated trustees, financial officers, and portfolio managers").

tion.²⁴³ The solution they hit upon was the private charitable foundation.

One of the touted virtues of this new philanthropic vehicle was its reliance on a staff of experts to assist in the selection of worthy grantees.²⁴⁴ Moreover, the grants were not to be directed at the symptoms of poverty and disease, but at their root causes.²⁴⁵ Both Carnegie, the chief theoretician of the new form of philanthropy, and Robert De Forest, the Wall Street lawyer who engineered the prototypical Russell Sage Foundation, were anxious to turn their expertise in industrial organization to the social problems that, in their own and their contemporaries' perception, the largely indiscriminate philanthropy of the past was not addressing.²⁴⁶

In the first half of this century these views gained wide currency,²⁴⁷ but they were probably more frequently accepted than implemented. Other than the philanthropies of Carnegie, the Rockefellers, and a very few others in their mold, most of even the larger private foundations remained largely ad hoc, ameliorative, family-centered operations.²⁴⁸ And probably most smaller foundations have both narrower purposes and much smaller staffs.²⁴⁹

²⁴³ Hall, *A Historical Overview of the Private Nonprofit Sector*, in *THE NONPROFIT SECTOR*, *supra* note 2, at 3, 10–11.

²⁴⁴ *Id.* at 11.

²⁴⁵ In an era that harkened to the rhetoric of self-help, if not social Darwinism, education was an early and obvious favorite. See *infra* note 251 for a further discussion of private foundations' interest in education.

²⁴⁶ Hall, *supra* note 243, at 12; Bremner, *Private Philanthropy and Public Needs: Historical Perspective*, in 1 *FILER COMMISSION PAPERS*, *supra* note 3, at 89, 100 (describing Carnegie as "fearful of impulsive generosity"); see also Council on Foundations, *supra* note 223, at 1558 (footnote omitted) (noting that the private foundation philanthropy of Carnegie, Rockefeller, and their ilk "sought . . . to turn the weapons of systematic investigation, experimentation, and research to the attack on many different kinds of human need"); Bremner, *supra*, at 101–02 (quoting John D. Rockefeller speech in which he explicitly called for organizing philanthropy along the lines of big business).

²⁴⁷ Ylvisaker, *supra* note 223, at 374–75.

²⁴⁸ W. NIELSEN, *supra* note 224, at 273–74; see also Ylvisaker, *supra* note 223, at 374 (many foundations do not conform to Carnegie-Rockefeller model). For foundations that do not follow the orthodox rhetoric of innovation and experiment, the stodgier side of banking may be an apt analogy:

The majority of them can be compared to bankers, waiting for loan applications to be presented; and like any careful banker, they tend to give preference to the applicants who are familiar, who can present good credentials, and who are generally "sound."

Nielsen, *supra* note 224, at 275. Nielsen also notes that the founding of many private foundations seems to reflect the abandonment, not the application, of organizational skills demonstrated in the donor's for-profit undertakings. *Id.* at 312–13.

²⁴⁹ See Ylvisaker, *supra* note 223, at 363–64.

4. The Need for Separate Organizations

The founders of private foundations are thus able to achieve economies of scale in their essential functions, investing and grant-making, without combining with others. They can either perform their investment function themselves or farm it out to others. With respect to disposing of income, economies of scale are important both in identifying grantees and in monitoring grants. But founders of foundations frequently have large enough personal estates to reach these economies on their own;²⁵⁰ all the great foundations are founded on the wealth of an individual or at most a family.²⁵¹

This raises two vital questions. First, why would wealthy philanthropists need or want a separate organization? Since private foundations tend to be their founders' philanthropic alter egos, why do their founders not simply do it themselves? Second, if there is a need for a separate organization, why would a for-profit or governmental entity not be adequate? We have already addressed these issues in connection with operating altruistic organizations, organizations like CARE and colleges that are engaged in providing goods and services themselves. Large-scale philanthropists also need separate organizations, but for reasons that are somewhat different.

A tempting answer to the first question is tax advantages. The foundation population virtually exploded in the high tax era following World War II, no doubt in large part because the deducta-

²⁵⁰ Indeed, some wealthy philanthropists simply hire professional staff to assist them in their grant making, without creating a separate legal entity. Ylvisaker, *supra* note 223, at 361 n.3.

²⁵¹ The need to achieve economies of scale in grant-making and monitoring may limit the size of private foundations other than those with very restricted scopes or very devoted founders. Below that threshold, donors may be able to achieve partial horizontal integration through community foundations that are formed to administer separate funds jointly. See *supra* note 223 for a further discussion of community foundations. Furthermore, though they may not need to integrate for these purposes, even the largest foundations occasionally find pooling of resources a helpful way to deal with problems too vast for their individual resources. This was the case, for example, at the beginning of this century in the collective efforts of northern philanthropists to address the deficiencies of southern education. John D. Rockefeller's General Education Board, founded largely in response to this problem, had all the earmarks of a corporate joint venture; "[t]he General Education Board was closely associated with the Southern Education Board, serving in effect as an interlocking directorate or holding company for vast philanthropic interests." C.V. WOODWARD, ORIGINS OF THE NEW SOUTH 403 (1971) (footnote that describes the relationships of these and other organizations concerned with southern education omitted). In the present era of dramatic cuts in governmental relief programs, it is not surprising that foundations are once again joining forces to stretch their resources. Ylvisaker, *supra* note 223, at 366-67 & n.20.

bility of charitable donations made philanthropy marginally less costly.²⁵² But though the combination of high tax rates and the charitable deduction generally spurred giving by wealthy, high-bracket taxpayers, there is less reason to think that it particularly encouraged use of the private foundation vehicle. Moreover, many of the larger foundations antedate the origins of federal income and transfer taxation. And even if there were no tax advantages to using the private foundation form, there would still be a significant reason for donors to establish distinct nonprofit entities as instruments of their grant making. That reason lies not in taxes, but in life's other certainty, death.

Facing the prospect of death, the wealthy have two basic choices as to the disposition of their accumulated assets.²⁵³ They can either leave it to friends, family, or other acquaintances, or they can place it in the hands of charity.²⁵⁴ Either way, death separates donors from donees, even more dramatically than the continental distances of the CARE example. In many cases, however, the donee can police the transfer. Unlike the intended recipients of CARE packages, the intended objects of decedents' bounty frequently know what to expect—they may well have the decedent's will in hand. Furthermore, administration of outright legacies to particular individuals and to designated charities is relatively uncomplicated.²⁵⁵ The only necessary institutional arrangement, the decedent's probate estate, arises virtually automatically at death and lasts in the normal course

²⁵² See *infra* note 270 for a discussion of the development of foundations in the era following World War II.

²⁵³ A third logical possibility—taking it with them—enjoys less appeal today than it did, apparently, in the time of the pharaohs. The decline in the popularity of this alternative is probably attributable to factors other than an increase in decedents' concern for those they leave behind.

²⁵⁴ In what follows, I imply that all private foundations are established at death in the legal form of a charitable trust. In fact, most are probably established during the founder's life in the form of nonprofit corporations. Analyzing them as testamentary charitable trusts has the heuristic value of facilitating comparison with other ultimate dispositions of individual wealth. Furthermore, I mean to suggest that the prospect of death is a primary reason for establishing all private foundations, even those that are created and funded *inter vivos*. Finally, the differences between charitable trusts and charitable nonprofit corporations, while by no means insignificant, see M. LANE, *LEGAL HANDBOOK FOR NONPROFIT ORGANIZATIONS* 15–21 (1980); P. TREUSCH, *TAX EXEMPT CHARITABLE ORGANIZATIONS* 35–45 (3d ed. 1988), can safely be ignored in this context.

²⁵⁵ The following account of the process of estate administration is highly compressed and, perhaps, a bit stylized. For a fuller, but still general, account, see W. MCGOVERN, S. KURTZ, & J. REIN, *WILLS, TRUSTS AND ESTATES* 575–709 (1988) (Chapter 14, Probate and Administration).

only until the decedent's assets can be expeditiously disbursed.²⁵⁶ The decedent's personal representative, who administers the estate, is frequently someone other than the estate's beneficiaries, presenting risks of diversion. But the personal representative acts under fairly direct supervision by the probate court and, in all probability, by the objects of the decedent's bounty, be they charities or individuals. The personal representative's fees are likely to be fixed by contract, if not by statute, and to be based on fairly readily monitored factors like time worked or value of assets administered. This, together with the high degree of scrutiny, makes it possible to employ for-profit firms for this function.

But decedents are not always satisfied with outright transfers; frequently they indulge the urge to exercise continued control from beyond the grave. Both basic forms of disposition, charitable and private legacies, leave considerable room for such control, and both illustrate the need for special institutional arrangements beyond those involved in outright testamentary gifts. The private trust offers testators an extraordinarily flexible means of influencing not only who gets their property after death, but also when and how that property can be enjoyed. Private trusts routinely provide, for example, that specified percentages of principal and income be paid to particular individuals at designated ages or at the occurrence of events like marriage, graduation from professional school, or purchase of a personal residence. And trust provisions can be tailored to avert anticipated problems; fortunes need no longer be at risk for bowls of porridge.²⁵⁷ Despite some notable opposition in the last century, "spendthrift" provisions can now be used in most American jurisdictions to protect the improvident from themselves.²⁵⁸ As long as the relevant conditions, triggering events, and amounts are stated in objective terms and the method of determining administrative

²⁵⁶ The case of *Jarndyce and Jarndyce* in C. DICKENS, *BLEAK HOUSE*, is a notable, though fortunately fictitious, exception.

²⁵⁷ For one that was, see *Genesis* 25:29-34.

²⁵⁸ The redoubtable John Chipman Gray of the Harvard Law School railed against spendthrift trusts in J. GRAY, *RESTRAINTS ON THE ALIENATION OF PROPERTY* (1st ed. 1883). Victory, however, went to the other side. On the current majority position, see generally W. MCGOVERN, S. KURTZ, & J. REIN, *supra* note 255, § 8.7, at 339-53; 2A A. SCOTT, *THE LAW OF TRUSTS* §§ 151-163 (W. Fratcher 4th ed. 1987); *RESTATEMENT (SECOND) OF TRUSTS* §§ 149-162 (1959). For an account of the tension between the right of free testation and the right of free transferability, see Alexander, *The Dead Hand and the Law of Trusts in the Nineteenth Century*, 37 *STAN. L. REV.* 1189 (1985). For a briefer account, especially of Gray's role, see J. DUKEMINIER & J. KRIER, *PROPERTY* 239 (2d ed. 1988).

fees is specified in advance, a for-profit firm will be entirely suitable as administrator of these arrangements. Indeed, that is precisely what trust companies and bank trust departments do.

The future is, of course, notoriously difficult to anticipate. Penitent prodigals may return to find forgiving parents dead;²⁵⁹ model offspring have been known to undergo striking changes of character upon coming into their inheritances even while their ancestors live.²⁶⁰ This problem is compounded by the fact that decedents can exercise postmortem control of the distribution of their wealth through private trusts for several generations.²⁶¹ Rather than try to anticipate all contingencies that might occur under such long-term trusts, testators sometimes try to build flexibility into their dispositive devices. The cost of flexibility toward the beneficiary, however, is discretion in the administrator, discretion that the testator may well not wish to delegate to a stranger. Such reluctance may have nothing to do with a fear that for-profit administrators will skim off excessive returns for themselves. Rates can be specified in advance, and individual beneficiaries or their legal guardians are practically positioned and legally empowered to police them through the modern equivalents of the courts of equity. Rather, the reluctance stems from the testator's inability to specify desires in advance in sufficient detail. For their part, institutional trustees may dislike the role of surrogate parent, preferring more definitive administrative standards. Accordingly, testators sometimes place such discretion in the hands of reliable family members or personal friends, who serve as co-trustees or advisory committees with power to make certain designated discretionary decisions.

Those who wish to leave their wealth to charity face a similar situation. They can simply leave their wealth outright to charity, or, somewhat more elaborately, they can establish a trust naming particular charities as beneficiaries of income or principal, at specified times and in stated amounts. As in the case of private trusts, for-

²⁵⁹ For the standard happier ending, see *Luke* 15:11-32.

²⁶⁰ See, e.g., W. SHAKESPEARE, *THE TRAGEDY OF KING LEAR*.

²⁶¹ The allusion, of course, is to the venerable Rule Against Perpetuities. In its classic formulation, the Rule provides that "[n]o interest is good unless it must vest, if at all, not later than twenty-one years after some life in being at the creation of the instrument." J. GRAY, *THE RULE AGAINST PERPETUITIES* § 201 (4th ed. 1942). The practical effect of the Rule is to permit "a man of property . . . [to] provide for all of those in his family whom he personally knew and the first generation after them upon attaining majority." 6 *AMERICAN LAW OF PROPERTY* § 24.16 (1952).

profit firms can and do make quite satisfactory trustees of such arrangements.²⁶² The only significant difference is that the policing of the fiduciary is done by charitable institutions rather than individual beneficiaries and is supplemented, at least in theory,²⁶³ by the state's supervisory authority over charitable trusts.

Like ordinary testators, however, those who leave their wealth to charity may want to exercise more subtle forms of control or to ensure less easily stated goals. Moreover, the identity of ultimate donees is likely to be even more uncertain than in the case of private trusts; the very point of the classic private foundation is to allow flexibility in the choice of donees over time. In the case of charitable bequests, the problem of distant horizons is compounded. Charitable trusts are not subject to any durational limit; in theory, they can last forever.²⁶⁴ The private foundation offers an institutional means by which wealthy testators can ensure that their charitable goals are pursued in their absence by a body of administrators hand-picked by the testators and, if the testators wish, replaced according to a prescribed procedure.

Here again, the problem is not that for-profit corporate administrators are more likely to defalcate. Indeed, individual trustees would seem to have equal incentive, and greater opportunity, to abuse their position—equal incentive, because they too are entitled only to adequate compensation for services rendered, and greater opportunity, because corporate trustees are subject to scrutiny by their own internal bureaucracies and to serious market as well as legal discipline in case of abuse. And governmental monitoring is no more difficult in the case of corporate trustees. Whatever the identity of the trustee, the agreement between the donor and the trustee for administration of the corpus is essentially a limited return arrangement, compliance with the terms of which can be policed through accountings and audits. In this respect Hansmann is right in the passage quoted at the outset of this subsection; the founder of a private foundation “obviously will want to impose some form of nondistribution constraint.”²⁶⁵ But that constraint will be

²⁶² Hansmann, *supra* note 17, at 853 n.53.

²⁶³ See *supra* note 27 for a list of sources discussing the supervisory function.

²⁶⁴ G. BOGERT, *THE LAW OF TRUSTS AND TRUSTEES* § 351 (rev. 2d ed. 1977); *RESTATEMENT (SECOND) OF TRUSTS* § 365 (1959); 4A A. SCOTT, *supra* note 258, § 365, at 109. John Simon has argued in an unpublished manuscript that charities are not so much exempt from the Rule as simply outside the scope of problems that the Rule is intended to address.

²⁶⁵ See *supra* notes 222–23 and accompanying text for a further discussion of Hansmann's ideas about private foundations.

essentially the same as the one imposed on the corporate trustee of a private trust for the benefit of identified individuals who can do their own monitoring. The trustee is to use the corpus as directed by the settlor and in return is to be paid according to a statutory or contractual schedule.

There are several reasons for this similarity between private and charitable trusts. First, almost any disposition one makes at death is altruistic, because the transferor by definition is not around to enjoy the fruits.²⁶⁶ The question is whether the benefits conferred by the decedent's transfer of wealth fall far enough from home to be characterized as charitable. Also, to the extent that the legacies are not outright, but subject to conditions, they involve an element of parentalism, whether the beneficiaries are defined as narrowly as one's children or as broadly as humanity. Finally, and most fundamentally, the issue of future disposition in both cases cannot be stated in terms of willingness and ability to pay; it must be stated in terms of some other criterion like need or merit. Sometimes these other criteria can be quantified: the son or daughter whose medical expenses exceed income, the student with SAT scores in the ninety-fifth percentile. When they cannot, the transferor may prefer individual trustees whose hearts are known to be in the right place, even though corporate trustees are no more likely to have their hands in the till.

Thus when beneficiaries themselves are not in a position to monitor administration, in the case of charitable trusts, as in the case of private trusts, government assumes a supervisory role. It is conceivable that an agency of the state could perform investment and disbursement functions as well. But there is no particular need, as individuals and for-profit firms are readily available. Moreover, the latter may well perform more cost-efficiently than the government because they have an incentive to keep their own costs down when they are compensated on a fixed-fee or salary basis. Finally, donors' inclination to want trustees they know and trust personally may reduce the appeal of governmental administration.

The government's monitoring role in charitable bequests does, however, come at a cost. The state allows resources to be set aside

²⁶⁶ The transferor may, of course, look forward to others' enjoyment of her largesse after she is gone or derive present pleasure from the prospect of future monuments to her memory. Perhaps from some vantage point in the Hereafter she can also look back (and up or down) on such things. For reasons given elsewhere, however, these intangible benefits can for our purposes be ignored.

in perpetuity only for publicly approved purposes. In this sense, charitable trusts and their modern progeny, private foundations, are a peculiar hybrid of private property and socialism. As Professor Simes said of the charitable trust in his classic lectures on public policy and the dead hand:

On the one hand, it is for the public benefit. Because of the public interest, the attorney general enforces it. Relief is provided by it to those who are the recipients of its bounty from the harsh, economic laws of an individualistic society, just as is furnished by the instrumentalities of the welfare state. But on the other hand, it gives full scope to the control of the dead hand, far beyond that which is possible anywhere else in the law. By this device, the vanity of the dead capitalist may shape the use of property forever.²⁶⁷

Perpetual existence is not, of course, the only benefit governments confer on these hybrid institutions. In section V we shall examine more closely a more active form of governmental benefit, the exemption of their income from federal taxation. Before turning to that, however, we need to look briefly at whether private foundations do in fact earn their immortality in the way that Professor Simes outlines.

5. The Ideal, the Real, and the Law

In our examination of private foundations, we have essentially taken their role to be that advanced by their advocates. Private foundations, in this view, are the Daddy Warbucks, if not quite the Heavenly Fathers, of philanthropy. Their critics, however, have argued since the days of Carnegie and Rockefeller that though private foundations have exhibited paternalism aplenty, they have not always lived up to their loftier ideals.²⁶⁸ Even private foundations' staunchest advocates admit that the proliferation of private

²⁶⁷ L. SIMES, PUBLIC POLICY AND THE DEAD HAND 110-11 (1955). See also Weisbrod, *supra* note 207, at 147 ("Combining an activity traditionally identified with governmental activity—provision of collective goods—with an attribute of private activity, the absence of legal compulsion to pay for benefits, nonprofit collective-goods firms may be thought of as hybrids.").

²⁶⁸ For a brief history of the criticism of private foundations in the United States, see Hall, *supra* note 243, at 12, 18-21; Nielsen, *supra* note 225, at 5-7.

foundations in the post-World War II era owed much to tax incentives²⁶⁹ and led to abuses.²⁷⁰

This is not the place to scrutinize, nor am I the person to defend, private foundations' track record. Yet, because my account depends so much on the ideal, I cannot entirely avoid the charge that it diverges rather sharply from the real. For my purposes the critical confluence of the two lies in the watershed year 1969, when the critics of foundations' performance gained ascendancy in Congress and secured amendments to the tax code strictly regulating the private foundation.²⁷¹ Those provisions subjected foundations engaging in the most egregious perceived abuses to graduated penalty taxes culminating in forfeiture of all their assets and loss of their federal tax exemption.²⁷² Most significantly for our purposes, the 1969 Act mandated that private foundations pay out annually a statutorily determined minimum amount either for the active conduct of charitable purposes or to organizations engaged in such activities.²⁷³ This latter provision in effect made the capital-providing ideal of private foundations' apologists the legal standard for their operation. Under the 1969 Act, if a private foundation is to operate in accord with federal law, it must practice at least that much of the role its advocates preach.²⁷⁴

²⁶⁹ Council on Foundations, *supra* note 223 at 1558; *see also* Hall, *supra* note 243, at 17 (noting that the relatively high federal income and transfer tax rates of the post-war era encouraged the formation of many private foundations that were "little more than tax dodges").

²⁷⁰ *See, e.g.*, Council on Foundations, *supra* note 223, at 1558 (citing the investigations of Rep. Wright Patman of Texas):

Investigations in the 1960s revealed that some persons had set up foundations more for personal advantage than for public benefit. Some, it was found, were benefiting friends and relatives; others were being used to maintain control of companies; some were hoarding assets and making almost no return to charity; and in a few damaging instances it appeared that foundation grants had been made to advance partisan political interests.

See also B. HOPKINS, *supra* note 237, at 429 ("More serious criticisms of private foundations are that they further various tax inequities, are created for private rather than philanthropic purposes, and do not actually achieve charitable ends."); Hall, *supra* note 243, at 17 ("[W]ealthy families were quick to recognize the utility of the foundation as a device for maintaining dynastic control over firms.").

²⁷¹ For a detailed political account of the 1969 Act's private foundation provisions *see* Nielsen, *supra* note 224, at 7-26.

²⁷² The new legislation imposed on private foundation managers higher fiduciary standards than those applicable to public charities, I.R.C. § 4941, precluded private foundations from owning controlling interests in business enterprises, and regulated or forbade a laundry list of unpopular private foundation activities, I.R.C. § 4943.

²⁷³ I.R.C. § 4942 (1988).

²⁷⁴ It is, of course, a different matter to claim that private foundations are in fact

Moreover, that role necessarily involves weak altruism. Founding grants to private foundations are but a special case of gifts for the benefit of others without expectation of material return. An essential purpose of the 1969 Act's private foundation provisions was to plug loopholes that had previously allowed founders and their families to draw off illicit private benefits from their purportedly charitable creatures. Founders' motives in creating a private foundation, even one meant to operate within the strict letter of the new law, may, of course, be anything but altruistic in the strong sense of pure selflessness. Founders of private foundations, no less than donors to operating nonprofits—no less, for that matter, than saints and martyrs—may be motivated by vainglory or fear or any of the other "wrong" reasons that impel people to do the right thing. Here again, the point for our purposes is that the founders of private foundations part with something objectively valuable without material return, if they operate within the law.

These founders may, as we have seen, retain a considerable say, directly or through their appointees, in the use of their donated property. It is this very voice—tolerated not only by applicable legal standards, but also by the theory of private foundations' proper role—to which a more radical school of foundation critics object. Their complaint is not with abuses of private foundation's role as philanthropic financiers. Their complaint is with that role itself, particularly with the amplified voice it gives the wealthy in public affairs.²⁷⁵ A strong case has been made that, under Rawlsian notions of justice, this enhanced position of a wealthy few is more than offset by the benefits private foundations confer on the public at large, particularly in view of the public's capacity, as seen in 1969, to alter dramatically the legal regime applicable to private foundations.²⁷⁶ This debate cannot be resolved here, but it takes us to the threshold of a larger, and logically anterior, issue: even if, as I have tried to show in this part, certain kinds of nonprofit organizations play a critical role in the altruistic provision of goods and services,

operating within the limits of the new law. Some commentators have so concluded, however. See B. HOPKINS, *supra* note 237, at 429 ("[N]early all of the abuses—perceived or otherwise—involving private foundations were eradicated as a result of the enactment of the Tax Reform Act of 1969.").

²⁷⁵ Simon identifies and answers this criticism in Simon, *supra* note 235. See also B. HOPKINS, *supra* note 237, at 429 (noting that private foundations are "chastised for being elitist, playthings of the wealthy, and havens of 'do-gooders' assuaging their inner needs by dispensing beneficence [sic] to others").

²⁷⁶ Simon, *supra* note 235.

do such organizations merit special treatment under the federal income tax? That issue is the subject of section V.

V. POLICY ANALYSIS—THE FEDERAL INCOME TAX EXEMPTION OF NONPROFIT ORGANIZATIONS

In section III we saw that the nonprofit sphere can be divided into nine types of organizations that exhibit altruism in one form or another and a tenth type of organization that, although genuinely nonprofit, is in no significant sense altruistic. We saw in section IV the need for altruism to take an institutional form, both to achieve economies of scale and to ensure continuity over time. In this section we turn to the normative issue of why—or whether—altruistic organizations' income should be exempt from federal income taxation. We will examine three existing theories of the federal income tax exemption, beginning with Hansmann's theory that the exemption is a means of helping nonprofit organizations overcome problems in acquiring capital for expansion. We will then compare Hansmann's theory with the traditional view that the exemption is a subsidy for favored activities and the view advanced by Boris Bittker and George Rahdert that the exemption merely reflects technical difficulties in defining nonprofits' income.

For purposes of this examination, it is useful to distinguish four basic kinds of income a nonprofit organization may have. These categories are hardly airtight; indeed, each of the three exemption theories implicitly conflates them at some points and explicitly collapses them at others. The categories are nonetheless useful, however, because they point to real differences between sources of nonprofit revenue, differences that are now reflected in different tax treatment and over which policy analysts disagree. The first of these is gift income, revenues received without a quid pro quo. The second is exempt function income, revenue derived from the sale of the goods or services the provision of which is the organization's reason for being. Passive or investment income, the third, is second-generation revenue, revenue generated by investing in passive vehicles like stocks, bonds, and rental property. The final category is unrelated business income, income generated by the active conduct of a trade or business that is not functionally related to the activity for which the organization was founded, except as a means of raising revenues to support that activity.²⁷⁷

²⁷⁷ I.R.C. § 512 (1988) (defining unrelated business taxable income); *id.* § 513 (defining unrelated trade or business).

To get these categories firmly in mind, consider again Mr. Orton's Ceramic Foundation.²⁷⁸ The revenues received from the sale of ceramic cones, the production of which was the primary purpose of the Foundation, are exempt function income. In the unlikely event that another ceramics aficionado donates money to the Foundation, these receipts would obviously be gift income. If this gift were used to buy stock in GM or Dow-Corning, the dividends earned would be passive income. If, instead of investing the donation in stocks, the Foundation were to purchase a local pizzeria franchise and operate it to generate additional revenues to support its ceramics research, those revenues would be unrelated business income.

We will first examine how the three policy theories deal with the gift, exempt function, and passive income of altruistic organizations. Discussing these three categories of altruistic income together reflects their essentially identical treatment under the tax code. Next, by way of contrast, we will examine the treatment of these income categories with respect to mutual nonprofits, the exemption of which is less expansive than, and based on different grounds from, that of altruistic nonprofits. We will then turn to unrelated business income, which is generally taxable even when received by altruistic organizations. In the background of these discussions is a question: Could the exemption of altruistic organizations' income in each of its various forms be considered simply a subsidy of altruism? In the final part of this section, we will examine that question more directly.

A. *Altruistic Organizations' Gift, Exempt Function, and Passive Income*

In the first part of this section, I begin with Hansmann's exemption theory, then compare it with the traditional subsidy theory and with Bittker and Rahdert's technical definition theory. By attending to Hansmann's criticisms of the other theories, I derive from them a synthesis that is an alternative to Hansmann's theory.

Before we turn to the substance of the various exemption theories, however, a terminological note is in order. We have already examined in considerable detail the parameters of my term "altruistic nonprofits." To avoid confusion, we now need to identify and

²⁷⁸ Edward Orton, Jr., *Ceramic Foundation v. Commissioner*, 56 T.C. 147 (1971). For discussion of the Orton case see *supra* note 132 and accompanying text.

distinguish the comparable terms the other theorists use. For Hansmann, the critical term is "nonprofit," because the tax exemption of all nonprofits, whether they be what I call altruistic or mutual, stands or falls together under the contract failure theory. Accordingly, in examining his theory, I will use the more inclusive term. The traditional subsidy theory and Bittker and Rahdert, on the other hand, focus on a particular kind of nonprofit organization that is roughly similar to my altruistic nonprofit. The traditional subsidy theory is concerned primarily with justifying the exemption of organizations that qualify for exemption under section 501(c)(3) of the tax code, organizations subsumed under the general heading of "charity."²⁷⁹ Bittker and Rahdert use the term "public service organization" to describe a class roughly coterminous with the tax-law class of charities.²⁸⁰ For reasons that will become clear below, both the tax law concept of charity and Bittker and Rahdert's public service organization substantially overlap with what I have identified as altruistic organizations. Accordingly, in discussing the traditional subsidy theory and Bittker and Rahdert's technical definition theory, I will let the theorists speak in their own terms, pointing out differences between the classes of organizations they discuss and the altruistic nonprofits I have identified only where the differences are significant.

²⁷⁹ There is, alas, one further level of terminological complexity. For purposes of section 501(c)(3), the term "charitable" has two overlapping meanings. The first, broader meaning subsumes all the purposes listed in 501(c)(3). In this sense, all organizations exempt under that section are collectively referred to as charities. "Charity" in a second, narrower sense refers to a residual subcategory of those purposes exempt under section 501(c)(3) but not specifically listed there. See *Exempt Organizations Handbook* (IRM 7751) (1989) ("The term 'charitable' refers not only to one of the purposes for which exemption is recognized under IRC 501(c)(3), but is also the generic term for religious, charitable, educational, and scientific purposes under that section."). To avoid confusion, I will use "charity" in the first, broader sense except as otherwise indicated.

²⁸⁰ The only apparent difference is that, in their illustrative list of public service organizations, Bittker and Rahdert include two categories, social welfare organizations and political parties, that are allowed to engage in lobbying and political campaign activities. Bittker & Rahdert, *supra* note 90, at 305. Section 501(c)(3) forbids organizations exempt under its provisions to engage in any political campaign activity and in more than an "insubstantial amount" of lobbying. These restrictions are arguably extraneous to the central purpose of section 501(c)(3) and difficult to justify on any grounds. See Clark, *The Limitation on Political Activities: A Discordant Note in the Law of Charities*, 46 VA. L. REV. 439 (1960). Lobbying and political campaign activity, at least when conducted by fairly broad-based membership organizations, are public goods like those that many charities provide. Perhaps for that reason, the income of social welfare organizations and political parties receives favorable treatment under sections 501(c)(4) and 527 of the I.R.C., respectively.

1. Hansmann's "Capital Formation Theory"²⁸¹

Hansmann's theory of the proper policy basis for the tax exemption for altruistic and other nonprofits rests on his theory of why nonprofits arise in a capitalist economy in which for-profits are the norm. As we have seen, Hansmann argues that nonprofits tend to arise in contract failure situations as the most efficient suppliers of goods and services. From this it is tempting to conclude that nonprofits should be encouraged by the indirect subsidy of a tax exemption to develop in industries identified as exhibiting contract failure. Hansmann insists, however, that this inclination not be indulged without further analysis:

[I]t is not obvious why a subsidy is needed to encourage nonprofits even where their development seems appropriate as a response to contract failure. Why can consumers not be trusted to select nonprofit rather than proprietary producers on their own in those situations in which nonprofits are to be expected to offer more reliable service? And, if there are cases in which consumers cannot in fact be trusted to make such a decision wisely, is not a tax subsidy a remarkably indirect response to the problem? Should not proprietary producers be outlawed entirely—or at least put under severe regulatory restraint—where they are obviously unsuitable but are likely to attract consumers nonetheless?²⁸²

Hansmann maintains that there is a less immediately apparent, but ultimately more satisfactory, reason for exempting the net revenues of such nonprofits from income taxation. This encouragement is needed because nonprofits, by definition forbidden to distribute net profits, are barred from a primary source of capital for expansion, equity investment. Moreover, they are likely to be unable to expand to an optimal size using either borrowed capital, donated capital, or retained earnings.²⁸³ The exemption of their income

²⁸¹ This exemption theory is set out in Hansmann, *supra* note 68.

²⁸² *Id.* at 70–71 (footnote omitted).

²⁸³ *Id.* at 72–74. In a similar vein, Powell and Friedkin suggest, on the basis of several empirical studies, that

the fundamental differences between nonprofit and for-profit organizations does not turn so much on intrinsic differences in organizational form or capability, or even on legal criteria that distinguish nonprofits from for-profits, as on differences in the availability of resources and the constraints associated with their acquisition.

Powell & Friedkin, *Organizational Change in Nonprofit Organizations*, in *THE NONPROFIT SECTOR*,

from taxation is an appropriate and effective form of encouragement, because it helps offset this disadvantage in access to capital by increasing nonprofits' ability to retain net earnings for expansion.²⁸⁴ If this is how nonprofits will use their enhanced net revenues,²⁸⁵ and if we accept the implicit normative premise that, other

supra note 2, at 180, 181. According to Hansmann, however, the limit on availability of resources to nonprofits is not an independent factor, but rather a function of the nonprofit constraint, the essential legal and economic difference between for-profits and nonprofits.

Empirical research on the effect of capital constraints on the responsiveness of nonprofits to changes in demand is inconclusive. Hansmann, *supra* note 5, at 38-39; Steinberg, *supra* note 61, at 133-34.

²⁸⁴ Hansmann, *supra* note 68, at 72-75. Cf. *Utah County v. Intermountain Health Care, Inc.*, 709 P.2d 265 (Utah 1985). In *Utah County*, in response to the dissent's argument that denial of property tax exemption to two components of a nonprofit hospital network would result in higher costs to patients, the majority argued that "[t]he far more logical assumption is that growth of the IHC system would possibly be slowed . . ." *Id.* at 276 (emphasis in original).

²⁸⁵ Whether they will so use them depends on at least two critical variables. The first we have seen before, see *supra* note 61 and accompanying text, and Hansmann makes it explicit again here, Hansmann, *supra* note 68, at 70 n.57: nonprofit managers, who are not subject to scrutiny by equity owners, may exert themselves less than their counterparts in for-profit firms to minimize costs. Nonprofits are thus preferable on efficiency grounds to for-profit alternative suppliers only when this efficiency loss is more than offset by the efficiency gains the contract failure theory predicts. *Id.*

Turning to the second variable, waste in this form is not the only alternative to using the tax subsidy for expansion. Hansmann maintains that nonprofit firms can use the increased retained earnings attributable to their tax exemption in either of two ways. They can increase present production, by purchasing increased amounts of variable inputs to combine with existing levels of capital, or they can increase future production, by investing in additional capital. How they decide between these two will, he asserts, depend on their relative preferences for present and future production.

All this assumes that nonprofits are selling their product at the prevailing market price. As Hansmann points out in a footnote, however, there is another option open to them: "they can sell their service, not at the market price, but at a lower price that is at or below the level that just covers variable costs plus depreciation, and hence accumulate no earnings with which to acquire additional capital for purposes of expansion." *Id.* at 78 n.74. Hansmann declines to explore that possibility, "in part because, in a sense, it does not really add anything new to the problem." *Id.* The below-market pricing can, he maintains, simply be viewed as a subsidy in the amount of the underpricing, which in effect adds that much to the firm's cost of providing the subsidized good. *Id.* Yet in undertaking that subsidy, the firm has elected to increase its costs contrary to the dictates of economic efficiency. The fact that this contra-efficiency behavior is open to all firms receiving the subsidy of tax exemption raises the possibility that the subsidy will in many cases not be used for capital expansion, the use that Hansmann asserts to justify the subsidy. Moreover, as we shall see below in notes 294-301 and accompanying text, *infra*, Hansmann rejects the notion that nonprofits should be subsidized to provide socially desirable goods below cost.

Hansmann himself has provided empirical evidence in support of his capital-formation hypothesis. Analyzing state tax exemptions, he found that the market shares of nonprofit firms tend to be greater where the value of their tax exemption, i.e., the rate at which they would be taxed if not exempt, is greater. Hansmann, *The Effect of Tax Exemption and Other Factors on the Market Share of Nonprofit Versus For-Profit Firms*, 40 NAT'L TAX J. 71 (1987).

things being equal, efficient allocation of resources is to be encouraged, then this is an entirely appropriate conclusion.²⁸⁶

Hansmann goes on, however, to draw the more dubious conclusion that the exemption should apply only to those nonprofits that arise in response to the kind of market failure he has identified. Hansmann concedes that "[i]f nonprofit firms could be demonstrated to have important efficiency advantages over for-profit firms under identifiable conditions other than contract failure, similar reasoning could justify granting tax exemption to nonprofit firms in those circumstances as well."²⁸⁷ This statement has several important implications. In the first place, despite his concession that there may be other forms of "efficient" nonprofits than those he has recognized, the tenor of his writings suggests that he believes the canon is essentially closed. Hansmann is willing to concede that some traditionally exempt charities that do not fit his efficiency criteria—in particular, those providing education, hospital care, nursing care, and day care—should continue to be exempt because, in "a significant fraction of these industries, . . . a substantial subset of consumers feels more comfortable patronizing a nonprofit."²⁸⁸ But Hansmann would continue the exemption only "[u]ntil we have better data suggesting that these consumers are mistaken,"²⁸⁹ and others would be even less generous.²⁹⁰

In the second place, and far more significantly, Hansmann implies that a defense of the charitable exemption can only be made in terms of economic efficiency. He reaches that position, however, only after making a considerable effort to show that neither of two

²⁸⁶ It is not, however, a conclusion that has gone unchallenged. James Bennett and Gabriel Rudney propose taxing receipts from the sale of any product unless (1) more than 50% of the cost of production is financed by gifts or grants, as opposed to sales receipts or investment income, and (2) the subsidized product is "directed at a specific recipient group or purpose deemed charitable." Bennett & Rudney, *A Commerciality Test to Resolve the Commercial Nonprofit Issue*, 36 *TAX NOTES* 1095, 1097-98 (1987). The first requirement would mean that virtually all commercial nonprofits would be subject to tax on their exempt function income. Moreover, with respect to all nonprofits, "[a]ll investment earnings except exempt interest [presumably under provisions applicable to all taxpayers] are taxable revenues under the commerciality test." *Id.* at 1097.

²⁸⁷ Hansmann, *supra* note 68, at 87 n.92.

²⁸⁸ *Id.* at 89.

²⁸⁹ *Id.* More recently, Hansmann seems less inclined to give such nonprofits the benefit of the doubt. Hansmann, *supra* note 15, at 634; see also Hansmann, *The Evolving Law of Nonprofit Organizations: Do Current Trends Make Good Policy?*, 39 *CASE W. RES.* 807, 818, 822-24 (1988-89) (urging continued contraction of scope of nonprofit tax exemption).

²⁹⁰ See *supra* note 286 for a discussion of the Bennett and Rudney view.

alternative theories is adequate. It is to these competing theories, and Hansmann's reasons for rejecting them, that we must now turn.

2. Traditional Subsidy Theory (Herein Mostly of I.R.C. Section 501(c)(3))

The traditional subsidy theory of the tax exemption for altruistic nonprofits, like Hansmann's capital formation theory, rests on a particular view of the role of nonprofit organizations in a society with a democratic polity and a capitalistic economy. The traditional view of charity's role is the provision of two kinds of public benefits. The first of these I will call primary public benefits, because they are inherent in the particular activities that the organization undertakes. Altruistic nonprofits generate primary public benefits either by providing goods or services that are deemed to be inherently good for the public or by delivering ordinary goods or services to those who are recognized as being especially needy. Health care and education are examples of products deemed to be inherently good; providing them to anyone, irrespective of need, is considered to produce public benefits. Providing food and shelter for the poor or otherwise disadvantaged is an example of benefitting an especially needy class; it makes no difference that the goods provided are themselves mundane.

Beyond these primary public benefits, charities are said to provide what I will call "metabenefits," benefits that derive not from what product is produced or to whom it is distributed, but rather from how it is produced or distributed. Traditional theory has identified two ways in which charities provide such "metabenefits." In the first place, they are said to deliver goods and services more efficiently, more innovatively, or otherwise better than other suppliers. In the second place, their very existence is said to promote pluralism and diversity, which are taken to be inherently desirable.²⁹¹

²⁹¹ For examples of these views, see B. HOPKINS, *supra* note 237, at 6-7 (charities foster "voluntarism and pluralism" and decentralized, efficient decision-making and resource allocation); L. SIMES, *PUBLIC POLICY AND THE DEAD HAND* 133-34 (1955) (commending the "pioneering element" in charitable trusts); Sacks, *supra* note 28, at 524 (citing "initiative of thought and action," "diversity of views and approaches," and "experimentation in new untried ventures"); Stone, *Federal Tax Support of Charities and Other Exempt Organizations: The Need for a National Policy*, 1968 U.S. CAL. TAX INST. 27, 45 ("objectives of pluralism and diversity").

This view is related to the defense of private foundations as "charitable entrepreneurs,"

Traditional theory explains the charitable exemption as a means by which the government encourages organizations engaging in activities that promote the public good, activities that provide the primary goods and metabenefits described above.²⁹² This theory rests on the fairly explicit premise that not only particular goods and services, but also particular modes of supplying them, can be identified as especially good for the public under neutral principles administrable by a government agency, the Internal Revenue Service, subject to judicial review.²⁹³

Hansmann suggests that economic efficiency might provide such a neutral criterion,²⁹⁴ but he finds it unnecessary to assess the

the most innovative and counter-majoritarian of charities. *See, e.g.*, M. FREMONT-SMITH, FOUNDATIONS AND GOVERNMENT 49-53 (1965) ("Foundations in a Pluralistic Society"); Belknap, *The Federal Income Tax Exemption of Charitable Organizations: Its History and Underlying Policy*, in 4 FILER COMMISSION PAPERS, *supra* note 3, at 2025, 2036 ("preference for private activity and diversity"); Simon, *supra* note 235.

Cf. F. GAMWELL, BEYOND PREFERENCE 150 (1984) (Many third sector organizations, including "health-delivery and social-service organizations," are "private regarding," in contrast to public-regarding associations that promote "those activities in which individuals may pursue the public world for its own sake and, thereby, maximize it.").

²⁹² This view is widely expressed by both courts and commentators. *See, e.g.*, *Bob Jones University v. United States*, 461 U.S. 574, 591 (1983) ("Charitable exemptions are justified on the basis that the exempt entity confers a public benefit—a benefit which the society or the community may not itself choose or be able to provide, or which supplements and advances the work of public institutions already supported by tax revenues."); M. FREMONT-SMITH, *supra* note 291, at 158 ("The grant of tax exemption to charitable entities and the allowance of tax deduction for charitable contributions represent an attitude of positive governmental encouragement of philanthropy which has been present in the American tax system since its inception."); B. HOPKINS, *supra* note 237, at 5 ("Clearly then, the exemption for charitable organizations is a derivative of the concept that they perform functions which, in the organizations' absence, government would have to perform; therefore, government is willing to forego the otherwise tax revenues in return for the public services rendered."); H. OLECK, NONPROFIT CORPORATIONS, ORGANIZATIONS, AND ASSOCIATIONS 277 (1988) ("these organizations perform functions which would fall squarely on the government if private volunteers were not willing to devote their time and energy to them."); Belknap, *supra* note 291, at 2038 ("the policy underlying the tax exemption of charitable organizations is motivated primarily by a desire on the part of government to encourage activities contributing to the general welfare"); Reiling, *Federal Taxation: What is a Charitable Organization?*, 44 A.B.A. J. 525, 595 (1958) (charitable exemption "differs only in method from a disbursement of government funds" and "therefore cannot be sustained at law except when the public interest is served in much the same manner as when public funds are properly expended") (footnote omitted); Stone, *supra* note 291, at 45 ("The principal justification for tax benefits granted to these organizations [charities] and their donors should be that they relieve the government of what might otherwise be necessary governmental functions which are better accomplished in this fashion than they would be through direct government expenditures or grants.").

²⁹³ A less ambitious—and less debatable—premise would be that the exemption of charitable organizations is a subsidy of those products and modes of provision that authoritative decisionmakers determine to be worthy of subvention, whether or not on the basis of a "neutral," or even articulable, definition of public benefit.

²⁹⁴ More particularly, Hansmann suggests that such a neutral basis would be the spillover

adequacy of the traditional subsidy theory with regard to particular purposes. Instead, assuming *arguendo* that certain goods and services should be subsidized, Hansmann maintains that a tax exemption limited to nonprofit suppliers is not generally an appropriate means. He raises two problems with the subsidy theory: its failure to explain, first, why for-profits supplying the same products are not also exempt, and second, why the subsidy is tied to net profits.

With respect to the first problem, Hansmann examines several arguments for subsidizing only nonprofits through the tax exemption, but finds that "none of these arguments is terribly compelling."²⁹⁵ One argument is that nonprofits produce public goods, goods the enjoyment of which cannot effectively be limited to those who pay and which thus are unlikely to be produced in optimal quantities by for-profit firms. Hansmann agrees that nonprofit producers of public goods merit tax exemption, though on slightly different grounds. Recall that organizations producing public goods are likely to be nonprofit under contract failure theory,²⁹⁶ and thus need subsidy under Hansmann's own capital-formation rationale for the exemption.²⁹⁷ As he points out, however, the exemption now applies to many organizations such as hospitals, schools, and nursing homes that provide essentially "private" goods. These "exceptions" in his view eat up the subsidy "rule" on which traditional theory says the present exemption rests.²⁹⁸

Another possible basis for limiting the subsidy to nonprofits is the fear that for-profit suppliers would use the subsidy to increase distributable profits rather than to increase output or lower prices. Hansmann points out, however, that, in a perfectly competitive economy without market failures, for-profit firms in the long run will tend to pass a subsidy on to consumers as well as nonprofits

benefits that the subsidized goods confer on others than their direct consumers. Hansmann, *supra* note 68, at 66. Presumably these goods would be subsidized up to the point at which the marginal dollar of subsidy produces only a dollar of beneficial externalities. This is, of course, to make economic efficiency the criterion of subsidization, and thus to define "benefit" in terms of what those able to pay are willing to pay. As we have seen, *supra* note 69 and accompanying text, desire—or need—beyond ability to pay is excluded from this calculus by definition. Efforts to "weight" the dollar-backed preferences of the poor are but partial solutions.

²⁹⁵ Hansmann, *supra* note 68, at 67.

²⁹⁶ See *supra* notes 56–58 and accompanying text for a discussion of the contract failure account of nonprofits that produce public goods.

²⁹⁷ See *supra* notes 283–86 and accompanying text for a discussion of the capital formation rationale.

²⁹⁸ Hansmann, *supra* note 68, at 68.

will.²⁹⁹ New firms will enter the subsidized industry to get the supranormal profits attributable to the subsidy, and the increased output will drive prices down, thus ensuring that the subsidy is passed on to consumers. Hansmann concedes that many markets in which charities and other nonprofits operate are characterized by market failures that would permit a for-profit to skim off any subsidy. But Hansmann calls this "a rather attenuated argument,"³⁰⁰ apparently for reasons we have already examined.³⁰¹

Hansmann thus scores telling points against the traditional subsidy theory's limitation of the tax exemption to nonprofit organizations that produce the good or service to be subsidized. So far, however, we have looked only at the kind of good or service provided, ignoring any reasons for favoring nonprofits based on the way they provide goods and services. We have not explicitly considered the metabenefits side of traditional subsidy theory. In a sense, Hansmann explains the function of all nonprofits in terms of how in certain instances of market failure they provide primary goods like disaster relief more efficiently than their for-profit counterparts. Moreover, he would limit tax exemption to those nonprofits that provide this metabenefit.

As we have seen, however, efficiency is only one of several metabenefits that the traditional subsidy theory attributes to nonprofits. The most prominent others are pluralism and diversity. Hansmann's economic analysis raises a critical question that is answered only implicitly and unsystematically in the traditional subsidy theory: Why are these metabenefits not provided in the market? More specifically, does not the free market provide the greatest possible pluralism and diversity?³⁰² Certainly not, if these asserted virtues are interpreted—or expanded—to include modes of resource allocation that are alternatives to government fiat on the one hand and ability to pay on the other. On this view, the free market

²⁹⁹ *Id.* at 67. The Utah Supreme Court raised a similar possibility in *Utah County v. Intermountain Health Care, Inc.*, 709 P.2d 265 (Utah 1985). "It may very well be, as a matter of public policy, that *all hospitals*, for-profit and nonprofit, should be granted a tax exemption because of the great public need they serve." *Id.* at 277 (emphasis in original). This should logically follow under traditional subsidy theory, the court reasoned, from the fact that "both provide the public with the same service." *Id.* at 278. The court did not speculate further on this possibility, however, because the Utah constitution would bar any legislative effort to offer such a generous exemption. *Id.* at 277.

³⁰⁰ Hansmann, *supra* note 68, at 68.

³⁰¹ See *supra* notes 281–82 and accompanying text for a discussion of these reasons.

³⁰² See Gergen, *supra* note 69, at 1410 ("If a good may be provided through the market, that mechanism promotes novelty and experimentation just as well.").

and its constituent for-profit firms by definition fail to supply the one metabenefit that charity by its nature does provide—altruism.

Even if there were a reason to subsidize nonprofit but not for-profit production, there remains the question of whether tax exemption is an appropriate vehicle for the subsidy. Hansmann points out that such a subsidy is proportional to retained earnings, and questions whether that linkage is justified under the traditional subsidy theory. In his view, “there is no reason to expect a positive correlation between the amount of a nonprofit’s retained earnings and the factors . . . that might justify a subsidy”³⁰³ Hansmann does not explain, however, why such a positive correlation is a necessary, as opposed to merely a desirable, condition for granting a subsidy. It may be that tax exemption, with its coincidental link to retained earnings, is the only politically feasible or practically administrable form of subsidy to altruistic nonprofits as a class. Sometimes half a loaf is better than none.³⁰⁴

More fundamentally, both Hansmann and the traditional subsidy theory may have created an illusory issue by describing the tax exemption as a subsidy. The search for a link between retained earnings and the reason for favoring the tax-exempt organization would be less exigent if the tax exemption were viewed not as a subsidy of some good—primary or otherwise—that the organization provides, but rather as a recognition that the revenue thus ex-

³⁰³ Hansmann, *supra* note 68, at 71.

³⁰⁴ At the risk of falling into the *tu quoque* fallacy, it is arguable that Hansmann has not shown why, if a positive correlation between retained earnings and the basis for the subsidy is necessary, his own capital formation theory meets the condition. Indeed, the closest he comes to addressing that issue is to say, in acknowledging the probable inadequacy of retained earnings as an adequate source of capital for expansion, that “at least such earnings have the advantage that they are likely to be proportional to the degree to which demand for the organization’s services exceeds its ability to supply them, since excess demand will generally permit the organization to raise its prices (or attract larger donations).” *Id.* at 74.

Hansmann has expressed a preference for a related form of proportionality between subsidy and volume of product subsidized in another context. He maintains that the current exemption from the unrelated business income tax of royalties that museums receive from the sale by others of reproductions of works in their collections “produces a subsidy that is neatly proportional to the publicly valuable service that the museum provides, which is acquiring expensive art works for display at low or no fees.” Hansmann, *supra* note 15, at 631. He does not, however, elaborate on how this proportionality of subsidy with purpose is achieved. The more likely relation would seem to be between royalties and the popularity of the art work reproduced; reprints of cozy Currier and Ives winterscapes probably sell more Christmas cards than, say, miniature facsimiles of *Guernica*. Thus, to the extent the mission of museums is to collect and display art works appealing to something other than popular tastes, the relation between reproduction royalties and museum purposes would seem to be inverse.

empted is for some reason not appropriately included in the tax base. From this latter perspective, Bittker and Rahdert envision quite a different theory of the tax exemption of altruistic organizations.³⁰⁵

3. Bittker and Rahdert's Technical Definition Theory

Bittker and Rahdert generally and enthusiastically accept the traditional subsidy theory's premise that charitable purposes and organizations are worthy of promotion.³⁰⁶ Moreover, they also find evidence of this rationale in the earliest legislative history of section 501(c)(3).³⁰⁷ But they point out two troubling practical problems with this theory. First, they find it difficult to measure the asserted virtues of charities.³⁰⁸ Second, they note that when countermajoritarianism is one of the asserted virtues, as it is particularly for private foundations, popularly elected legislators will be predictably unimpressed.³⁰⁹ Indeed, in their view, the decline in legislative tolerance for tax exemption of nonprofits warrants a re-examination of its policy basis.³¹⁰

Bittker and Rahdert's canvass of the early legislative history of section 501(c)(3) indicates that the basic reason for the exemption of nonprofits was that the income tax could only logically be levied on activities for profit.³¹¹ Bittker and Rahdert accept this nascent rationale as essentially sound, faulting it only insofar as it fails to distinguish between what they take to be the two functionally different forms of nonprofits.³¹² The first of these Bittker and Rahdert describe as "public service organizations," because they "serve the interest of society in a broad sense, ordinarily without economic benefit to their organizers or benefactors."³¹³ By contrast, the other broad category of nonprofits, which they call "mutual benefit organizations," "are operated primarily for the benefit of their members; they are nonprofit only in the limited sense that they do not engage in business with the general public for the benefit of investors."³¹⁴

³⁰⁵ Bittker & Rahdert, *supra* note 90.

³⁰⁶ See *id.* at 332-33.

³⁰⁷ *Id.* at 304.

³⁰⁸ *Id.* at 332-33.

³⁰⁹ *Id.* at 342.

³¹⁰ *Id.* at 301.

³¹¹ *Id.* at 302-04.

³¹² *Id.* at 305.

³¹³ *Id.* at 302.

³¹⁴ *Id.* (footnote omitted).

We will examine below why, and to what extent, Bittker and Rahdert believe mutual benefit organizations should be exempt from income taxation. Our present concern is to examine their claim that all forms of public service organizations' income should be exempt. They identify two fundamental problems with taxing the income of such organizations: first, their net income cannot be made to fit under any workable tax definition of income, and second, even if it could, no appropriate tax rate could be applied to them.³¹⁵

With respect to the definition of income, Bittker and Rahdert point to problems on both the revenue and the expenditure sides of the ledger. On the revenue side, the basic issue is whether to treat dues and contributions as the equivalent, for tax purposes, of business income or, alternatively, as gifts or capital contributions. If dues and contributions are treated as the latter, Bittker and Rahdert maintain, they are excluded from the computation of gross income under provisions of the tax code generally applicable to individuals and for-profit corporations.³¹⁶

On the disbursements side, one basic issue is whether expenditures for the conduct of the organization's program should be deductible as analogous to ordinary and necessary business expenses or nondeductible as not intended to make a profit.³¹⁷ Another basic issue is whether the current charitable deduction could be stretched or amended to cover such payments.³¹⁸ If either of these issues is resolved in favor of deductibility, as Bittker and Rahdert suggest they should be, the taxable income of public service organizations will essentially be reduced to zero, because all their assets are ultimately dedicated to their organizational programs.³¹⁹ Thus, even if a workable definition of public service organizations' income could be developed, the game would not be worth the candle.

Furthermore, Bittker and Rahdert argue that, even if a workable definition of their income could be developed, there would be insurmountable problems in finding the appropriate rate at which to tax it under either current theory of appropriate tax rates, the "benefit" or "ability to pay" theories. The primary reason for this is that, ideally, the rate should reflect the individual rates of the or-

³¹⁵ *Id.* at 305.

³¹⁶ *Id.* at 307-09.

³¹⁷ *Id.* at 309-12.

³¹⁸ *Id.* at 312-13.

³¹⁹ *Id.* at 311-12 (business expense deduction), 313 (charitable deduction).

ganizations' beneficiaries, many of whom are likely to be poor and thus "over-taxed" by any rate. Thus, if the game of taxing public service organizations were to be played, the predictable losers would be their beneficiaries.³²⁰

Hansmann takes issue with Bittker and Rahdert on both the income-defining and rate-setting difficulties they identify. Before turning to those specific criticisms, however, it is important to underscore a salient formal feature of Bittker and Rahdert's argument. As I have pointed out, they indicate at the outset their basic agreement with the traditional subsidy view, that is, with the position that there are affirmative features of public service organizations that warrant favorable tax treatment. This belief, however, is extraneous to their own argument in favor of the tax exemption. Their argument is not that the traditionally identified virtues of altruistic nonprofits make the tax exemption of their income desirable; rather, their point is that peculiarities of that income—in particular, its ultimate destination—make its tax exemption a practical necessity. This distinction must be borne in mind in assessing Hansmann's critique of the technical definition theory. Even if he shows that the characteristic of altruistic nonprofits that Bittker and Rahdert identify does not make their tax exemption necessary, he may not have shown that their tax exemption is necessarily a bad idea.

Hansmann offers several reasons why the problem of fixing an appropriate tax rate for public service organizations is a red herring. In the first place, he argues that, even as applied to businesses, the corporate rate is seldom justified in terms of the "ability to pay" of those on whom the tax ultimately falls. The incidence of the corporate income tax is uncertain, and sometimes corporations are viewed as having tax-paying capacities in their own right.³²¹

In the second place, Hansmann maintains that even if the incidence of the tax were an appropriate concern, it would not present a problem: "[I]t is not obvious that the ultimate incidence of an income tax levied on nonprofits would be especially regressive."³²² For one thing, donors are likely to share the burden with beneficiaries. Donors will probably increase their giving to some extent in order to offset the tax, rather than simply allowing less of their gifts to go to charities' beneficiaries. To the extent that the tax burden thus falls on donors, who are generally well-heeled, an

³²⁰ *Id.* at 314–15.

³²¹ Hansmann, *supra* note 68, at 65.

³²² *Id.*

income tax on nonprofits would not be regressive. And the beneficiaries of nonprofits are themselves often well-to-do, whether the organization receives its revenue from donations (as in the case of museums, schools, and performing arts groups) or from sales of goods or services (as in the case of private colleges and hospitals). Finally, the exemption only benefits those charities that retain revenues from year to year, as opposed to those like the Salvation Army that pass their revenues directly through to their beneficiaries. Charities of the former sort, those that retain revenues in the form of endowment funds or capital expenditures, "are generally organizations, such as private schools, colleges, and hospitals, that disproportionately serve the well-to-do."³²³

Each of these criticisms is answerable, if not quite in Bittker and Rahdert's own terms. Even if Hansmann is right that Bittker and Rahdert misstate the conventional theory of corporate income taxation, their theory of the exemption would still leave an intelligible basis for taxing for-profit corporations. In effect, their technical definition of income, if extended to all altruistic nonprofits, would simply convert the corporate income tax into an excise tax on net earnings distributable for owners' private consumption.³²⁴

With respect to the regressivity problem, both Hansmann on the one hand and Bittker and Rahdert on the other take too narrow a perspective. Even on the assumption that progressivity is an appropriate goal of the tax system as a whole (an assumption all right-thinking people held in a kinder, gentler time), progressivity need not be present in every part of that system. Thus, one might tolerate an element of regressivity in the tax exemption of elite cultural institutions in the name of altruism, as long as the difference is made up elsewhere in the system.

³²³ *Id.* at 66.

³²⁴ Hansmann acknowledges this prospect but dismisses it with the following observation:

This argument proves too much, however, for it suggests that *all* nonprofit corporations should be exempt, whereas exemption has in fact always been available only to certain categories of them, and so far even the strongest supporters of the exemption have not suggested that it be extended to all organizations that are legitimately formed as nonprofit corporations.

Id. at 64 (emphasis in original; footnotes omitted). This suggestion is precisely the thesis of this part of my paper, which I elaborate at *infra* notes 333-36 and accompanying text. Hansmann notes that this suggestion could be rejected on the argument that either nonprofit organizations themselves or those who receive their services should be viewed as the ultimate owners of nonprofits' capital. Hansmann, *supra* note 68, at 64. As he correctly points out, however, the fact that such analogies *could* be made does not mean they *should* be dispositive. *Id.* This is all the more true when, as we have seen in this very connection, contrasting analogies can also be drawn.

Finally, in his assertion that tax exemption benefits only non-profits that retain earnings, Hansmann begs important questions raised by Bittker and Rahdert. On the one hand, to reach the conclusion that highly redistributive charities like the Salvation Army do not benefit by the tax exemption, one must assume that their distributions would be deemed deductible expenses. Only if these expenditures are deductible do organizations that distribute all revenues within the annual tax accounting period have no taxable income. If these expenses are not deductible, then the benefits the Salvation Army confers upon indigents would have to be purchased with after-tax dollars. Whether these expenditures would be deductible is an open question. As Bittker and Rahdert point out, these expenditures do not fit comfortably within the current definition of ordinary and necessary business expenses, with its emphasis on profit-earning motivation.³²⁵

On the other hand, to reach the conclusion that capital-intense organizations actually benefit from the exemption, one must assume negative answers to the questions Bittker and Rahdert raise about the scope of the depreciation deduction. If, contrary to Hansmann's assumptions, capital-intense organizations' plant and equipment were subject to sufficiently generous depreciation allowances, their potential taxable income might, as Bittker and Rahdert suggest, be effectively eliminated, albeit more indirectly and awkwardly than under the present system of outright exemption.³²⁶

Thus, Hansmann's assault on the rate-setting difficulty is not especially effective. He has considerably greater success, however, attacking the more critical premise of the technical definition theory, the purported problem of constructing a workable definition of altruistic organizations' income.³²⁷ In the first place, as he points out, many charities receive most of their revenues not from donations, as Bittker and Rahdert tend to assume, but from the sales of goods and services directly to consumers. Hospitals are an obvious example. Hansmann argues that:

For such organizations it would be perfectly easy and natural to carry over the tax accounting that is applied to business firms, taking receipts from sales as the measure of gross income and permitting the usual deductions for expenses incurred in producing the goods or services sold.

³²⁵ Bittker & Rahdert, *supra* note 90, at 309-10.

³²⁶ *Id.* at 313-14.

³²⁷ Hansmann, *supra* note 68, at 58-62.

The resulting net earnings figure could be taxed just as in the case of a business firm.³²⁸

Hansmann, as we have seen, is perhaps too glib in his reference to "the usual deductions." Read one way, Hansmann may be implicitly answering the question Bittker and Rahdert pose—are distributions to altruistic organizations' beneficiaries, in kind or cash, to be treated as deductible?—in the affirmative.³²⁹ But that question could plausibly be answered in the negative. If by "usual deductions" Hansmann has in mind "ordinary and necessary business expenses," then such deductions could quite consistently with current concepts be limited to those expenditures necessary to the production of income. Disposing of income earned is obviously a different matter, and could be treated less favorably.

But to say that ordinary concepts of income measurement could be carried over to the income of commercial nonprofits is not to say that they should be. Nor is it clear why applying these concepts in the nonprofit context is any easier or more natural than applying the very different approach suggested by Bittker and Rahdert. As a descriptive matter, Hansmann is quite right that the receipts of commercial nonprofits closely resemble those of their for-profit counterparts. At the same time, Bittker and Rahdert are equally right in pointing out that the distribution of receipts in the two cases is quite different. Identifying these characteristics of nonprofits—similarities to for-profits on the one hand and differences from them on the other—leaves entirely unanswered the normative question of whether their income should be treated the same. Hansmann's assimilation of the income of commercial nonprofits to that of for-profit firms shows that the taxation of the former's income is possible, not that it is appropriate.

This confusion of the possible with the desirable is still clearer in Hansmann's discussion of the revenues of donative nonprofits. He argues that, even for charities that receive most of their revenue in the form of donations, "there is a natural correlate to the concept of taxable income developed for business entities."³³⁰ This is Hansmann's now-familiar equation of purchases and donations. To use an only slightly tendentious example, CARE could be taxed on the donations it receives, just as GM is taxed on its sales revenues. To

³²⁸ *Id.* at 59.

³²⁹ Hansmann has indicated in private correspondence that the answer is "Clearly yes, in my view." Letter from Henry Hansmann to Rob Atkinson (Dec. 13, 1989).

³³⁰ Hansmann, *supra* note 68, at 61.

use Hansmann's example, your paying Tiffany's to send a wedding gift to a friend is structurally "much the same as if you give to the Red Cross money to spend on food for a flood victim; in each case you are paying an organization to render services to a third party."³³¹ The obvious point of identifying this structural similarity is to suggest that the Red Cross could be taxed on the excess of its donation revenue over operating expenses, just as Tiffany's is taxed on its net profits. Hansmann explicitly universalizes this conclusion immediately after the Tiffany's example: "Thus, it seems that without much difficulty we can extend to nonprofits the general principles of tax accounting commonly applied to profit-seeking firms."³³²

The strength of Hansmann's critique of Bittker and Rahdert's theory is to point out that all the questions they raise about the definition of altruistic nonprofits' income are technically answerable on fairly straightforward analogies to the income of for-profit firms. This might require a degree of complexity, even convolution, but these would hardly be novelties to the tax code. Thus, if we are not to extend ordinary principles of income taxation to nonprofits, we must look for a normative, rather than merely a technical, reason. Tiffany's net income available for distribution to its stockholders is arguably different from the Red Cross's distributions of donations to flood victims, but the two could be made subject to tax with roughly equal convenience. But again, that only poses the normative question: Should we make this extension?

Though Bittker and Rahdert fail to show us that the taxation of altruistic organizations' income is practically impossible, they confirm a point made in more detail in section IV. Altruistic nonprofits differ from their for-profit counterparts, if not in the nature of their revenues, then certainly in the identity of their beneficiaries. As we shall see in the next subsection, it is possible at least in theory to take this distinction as a substantive, as opposed to a technical, basis for the favorable tax treatment of altruistic nonprofits.

4. Altruism Itself as the Basis of the Tax Exemption of Altruistic Nonprofits

An alternative to Hansmann thus emerges from this assessment of the traditional subsidy theory and the technical definition theory

³³¹ *Id.* at 61-62.

³³² *Id.* at 62.

in light of Hansmann's efficiency criterion. In this subsection I will first compare the altruism theory with the other theories in the abstract. I will then illustrate the differences in outcome that the different theories produce by applying them to an example. As we shall see, the altruism theory is essentially a synthesis of the traditional subsidy theory and Bittker and Rahdert's technical definition theory. In the final subsection we will look more closely at the merits—and demerits—of the altruism theory itself.

The best way to see both the indebtedness of the altruism theory to the other theories and its differences from them is to begin with the Code's definition of charity in section 501(c)(3)—the definition that the traditional subsidy theory defends. That definition has two essential criteria, the affirmative requirement of a purpose that produces public benefits and the negative prohibition of private inurement and excessive private benefit.³³³ Traditional subsidy theory focuses on the affirmative criterion, attempting to justify the favorable tax treatment of charities in terms of the public benefits flowing from the particular kinds of activities they undertake. The metabenefits associated with the manner in which the preferred activities are conducted figure prominently in theoretical defenses of the existing scope of the exemption, but not in the framework of the exemption itself.³³⁴ And in both the legal definition and its traditional defense, the prohibition of private inurement is something of an afterthought, perhaps based on what Hansmann shows to be the dubious assumption that for-profit firms would invariably skim off any subsidy in the form of additional profits.

Bittker and Rahdert, by contrast, focus on the negative criterion, the prohibition of private inurement. The peculiarity of their public service organizations' income lies ultimately in its not being available for distribution to private investors. Bittker and Rahdert simply assume the legitimacy of the affirmative requirement that exempt organizations pursue a purpose approved by the Code as redounding to the public benefit.

Hansmann argues that linking the prohibition of private inurement with the affirmative requirement of providing certain primary benefits is at odds with the idea of subsidizing those benefits. This is because for-profit firms, which are excluded from the sub-

³³³ I.R.C. § 501(c)(3) (1988); Treas. Reg. § 1.501(c)(3)-1(a), (b), and (c) (as amended in 1976) (setting out general exemption criteria).

³³⁴ An element of the metabenefit of altruism, however, does occasionally appear at the margin, as I discuss more fully *infra* note 335.

sidy by the private inurement prohibition, will pass any subsidy on to consumers under conditions of reasonable competition. Under his own theory, by contrast, the private inurement provision is essentially related to the rationale for the subsidy. The subsidy is designed to promote the metabenefit of efficiency, and only non-profit firms address the kinds of contract failure and experience the kinds of capital constraints that warrant efficiency-based relief.

The altruism theory of the tax exemption combines these three elements—primary benefits, metabenefits, and the private inurement prohibition—differently. Like the Hansmann and traditional subsidy theories and in contrast to Bittker and Rahdert, the altruism theory rests on the premise that the favorable tax treatment of altruistic nonprofits is an affirmative preference for something they provide. It also builds on the traditional theory's insight that the desirable attributes include not only primary benefits, but also metabenefits. Yet it incorporates Hansmann's criticism that it makes no sense to subsidize only nonprofit producers of primary benefits. Furthermore, it counters Hansmann's observation that for-profits may also supply some metabenefits like pluralism and diversity with the observation that one metabenefit, the altruistic provision of goods and services, is available only from nonprofits.³³⁵

³³⁵ Though a complete comparison of section 501(c)(3)'s exemption criteria and the altruism theory lies beyond the scope of this paper, it is important not to exaggerate the differences. In its application, if not in its articulation, section 501(c)(3) may well exhibit substantial overlap with the scope of the exemption that would follow from the altruism theory. One commentary on the traditional subsidy theory has shown that the standard for exemption under the residual category of "charity" of section 501(c)(3) requires a "donative factor," that is, "the provision of goods or services at no charge or at a charge below cost." Persons, Osborn, and Feldman, *Criteria for Exemption Under Section 501(c)(3)*, in 4 FILER COMMISSION PAPERS, *supra* note 3, at 1909, 1947-50 (1977) [hereinafter *Criteria*]. The required degree of donativeness under § 501(c)(3) varies according to the goods and services provided, *id.* at 1948-49, probably reflecting an implicit preference for the delivery of certain products or the delivery of any kinds of products to certain recipients. This preference may also account for the fact that, outside the residual category of charity, organizations performing exempt functions listed in section 501(c)(3)—education, for example—are not explicitly required to exhibit any degree of donativeness in the form of either below-cost sales or donative financing. Indeed, some have suggested that this may be increasingly true of even the residual charitable category: "as the criteria pertaining to charitable organizations evolve in response to changing conditions in society, it is possible that some charitable activities will be exempted from the donative requirement altogether, just as education is now so exempted." *Criteria*, *supra*, at 1949. This rather misleadingly suggests, however, that the latter organizations lack altruism. As we have seen, Type 7 organizations—commercial entrepreneurial nonprofits that operate for the benefit of their consumers—exhibit a degree of altruism, or donativeness, to the extent that they sell their products at a price that covers all costs but that of capital.

Nevertheless, the scope of exemption under section 501(c)(3) is probably both more and less inclusive than it would be under the altruism theory. Section 501(c)(3) does not cover

Altruism is close to the structural uniqueness that Bittker and Rahdert emphasize about the income of altruistic nonprofits. But the altruism theory accepts Hansmann's argument that the exemption of this form of income is not a technical necessity. It is, rather, a deliberate social policy choice that must be made on non-efficiency grounds, grounds other than those Hansmann maintains are the sole legitimate basis for the exemption. This is not to say that he is wrong in pointing to an efficiency-based rationale for exempting some altruistic organizations. But it is to say that he is wrong if he thinks he has discovered the one true way, the sole reason why altruistic nonprofits might be given favored tax treatment. In summary, the altruism theory takes the formal aspect of altruistic organizations that Bittker and Rahdert identify and offers it as a substantive metabenefit meriting tax subsidization.

Mr. Orton's Ceramic Foundation is again a useful example, this time for illustrating the practical implications of the different exemption theories. Under Hansmann's theory, the Foundation would be denied exemption because the production of pyrometric cones exhibits none of the forms of contract failure he identifies. The cones are private goods, and their purchasers, who are their consumers, are likely to be specialists quite capable of monitoring their quality. The Foundation, of course, has a monopoly on cone production by virtue of its patent, but the production itself could readily be conducted by for-profit licensees.

The altruism theory would exempt the Foundation's income because it is being used to subsidize consumption by someone other than those who control the organization, in this case, those who use pyrometric cones in ceramics research. Under this theory, there would be no inquiry into the merits of such research, no search for public benefits flowing from it. The metabenefit of altruistic production would suffice, at least *prima facie*.

altruistic provision of goods or services independent of the nature of the product or the need of the recipient. *See, e.g.,* *Christian Stewardship, Inc. v. Commissioner*, 70 T.C. 1037, 1045 (1978) (denial of charitable status to organization that offered free advice on charitable giving aspects of estate planning to prospective donors to affiliated religious organizations); Weisbrod, Book Review, 11 PUB. CHOICE 111, 114 (1971) (reviewing T. IRELAND & D. JOHNSON, *THE ECONOMICS OF CHARITY* (1970)); *see also* Sacks, *supra* note 28, at 520 ("[W]hen activities have been adjudged adequately performed through the market mechanism, they have not been regarded as philanthropic, even though organized on a nonprofit basis."). On the other hand, section 501(c)(3) exempts some mutual organizations even though they provide essentially private goods to their members on an ordinary contractual basis, as long as these goods are deemed to redound to the "public benefit." *See Sound Health Assoc. v. Commissioner*, 71 T.C. 158, 191 (1978) (recognizing charitable status of member-controlled health maintenance organization).

By contrast, after ascertaining that the threshold test of non-inurement is met, traditional subsidy theory would focus on the nature of the good provided to determine whether it conferred the kind of public benefit that warrants tax exemption. In ruling on the Foundation's exemption, the majority and the dissent in the Tax Court differed on precisely this issue. Bittker and Rahdert's approach has no problem justifying the majority decision; the Foundation has no income distributable to equity owners. But if the dissent were to prevail on the issue of public purpose, the technical definition theorists would face a dilemma. They would have to decide whether to follow the altruism theory in extending the exemption to all altruistic nonprofits, irrespective of the kinds of goods or services they provide, or the traditional subsidy theory in limiting the scope of the exemption to those organizations that provide primary public benefits recognized by the courts. Bittker and Rahdert fairly explicitly adopt the latter position.³³⁶

B. *Mutual Benefit Organizations*

Mutual benefit nonprofits provide a helpful comparison to altruistic nonprofits at this point. I have argued that the locus of altruistic organizations' benefits may serve as the basis for their tax exemption. This subsection briefly examines whether the same can be said of mutual benefit organizations. In this connection, traditional subsidy theory is less helpful. But here again, the debate between Bittker and Rahdert on the one hand and Hansmann on the other raises an implicit policy issue that cannot be resolved in terms of Bittker and Rahdert's technical analysis and that need not be decided solely on the basis of Hansmann's economic analysis. Bear in mind, however, that this treatment of mutual benefit organizations is merely offered for the sake of comparison and symmetry, not to add much that is new, much less to say the final word.

As with altruistic nonprofits, a preliminary terminological note is in order here. By "mutual benefit nonprofit" I mean a Type 10 organization, a nonprofit that derives its revenues from sales of ordinary consumer goods or services to its members, who control the organization and for whose benefit it operates.³³⁷ Bittker and Rahdert use the term "mutual benefit organization" in essentially

³³⁶ Bittker & Rahdert, *supra* note 90, at 331-32.

³³⁷ See *supra* notes 163-79 and accompanying text for a discussion of Type 10 organizations.

the same way,³³⁸ but cover two identifiable additional kinds of organizations. First, they include consumer cooperatives, which, as we have seen, are distinct from Type 10 organizations only in that they are permitted to confer benefits on their members in cash as well as in kind. Second, Bittker and Rahdert implicitly include, or at least do not explicitly exclude, mutual nonprofit organizations that I classify as altruistic because they provide their members with either public goods or "socialized" private goods. With these slight differences noted, however, it is safe to view Bittker and Rahdert's mutual benefit nonprofits as coterminous with my Type 10 nonprofits. Hansmann's four-part typology of nonprofits, as we have seen, does not distinguish mutual commercials operated for members' benefit from those operated for the benefit of others. Because Hansmann's tax policy discussion is limited to the former, his description of mutual commercial nonprofits overlaps almost precisely with my Type 10 and Bittker and Rahdert's mutual benefit nonprofits. Accordingly, I will use Bittker and Rahdert's more familiar term, mutual benefit nonprofit, throughout the following discussion.

1. Traditional Subsidy Theory

With respect to mutual benefit organizations, the traditional subsidy theory is less well articulated. In part, it follows the "public benefit" theory of the charitable exemption.³³⁹ In part, it acknowledges that the historical bases for tax exemptions of many section 501(c) organizations are obscure and perhaps better explained in terms of political power than policy merit.³⁴⁰ This is perhaps reflected in the fact that, in dealing with these organizations and their close kindred, consumer cooperatives, in the Tax Code, "Congress has preferred piecemeal legislation to broad generalizations."³⁴¹ As a result, it has "established many divergent taxing systems, which turn on such variables as the organization's size, function, history, and occupational or geographic conditions."³⁴²

³³⁸ Bittker & Rahdert, *supra* note 90, at 302.

³³⁹ See P. TREUSCH, *TAX-EXEMPT CHARITABLE ORGANIZATIONS* 5 (3d ed. 1988) ("This welter of categories [in I.R.C. § 501(c)] . . . suggests that the granting of tax-exempt status is aimed either at encouraging private organizations and public instrumentalities to take on a task that must otherwise be met by governmental appropriation or at fostering some activity regarded as fundamental or socially desirable.").

³⁴⁰ See McGovern, *The Exemption Provisions of Subchapter F*, 29 *TAX LAW* 523 (1976).

³⁴¹ Bittker & Rahdert, *supra* note 90, at 349.

³⁴² *Id.* at 349.

2. Bittker and Rahdert's Theory

Bittker and Rahdert manage to hear two contrapuntal themes in the Code's cacophony, themes suggesting that some forms of mutual benefit income should be taxed and other forms exempt. Bittker and Rahdert derive the exemption of their exempt function income—in their case, the excess of revenues from sales to members over costs—from the purpose of these organizations, which is “to provide goods and services to their members at cost.”³⁴³ Organizations that operate for that purpose in effect simply return net revenues to members as refunds for overcharges, albeit in kind rather than in cash.³⁴⁴ To put the matter in terms we used in section III, the locus of benefit is the organization's members. On the analogy of net revenues to refunds, Bittker and Rahdert argue that they should not be taxed at the organizational level. Rather, the organization is properly viewed as an aggregate of its members, none of whom would be taxed as an individual on receiving overcharge refunds.³⁴⁵ This is the principle theme that Bittker and Rahdert perceive in the tax exemption of mutual benefits.

There is, however, a counterpoint. What happens if the organization does not immediately expend the overcharge for members' benefit, but instead invests it to generate passive income used later, say, to reduce membership fees or product prices? Under Bittker and Rahdert's theory of mutual benefit organizations as aggregates of their members, their passive income should be taxed. If the members themselves received individual refunds and invested them, the proceeds would be ordinary taxable income; by leaving the refunds in the organization, the members have simply pooled their individual accounts.³⁴⁶ Otherwise, the members would be receiving tax advantages by doing things together that they could not receive by doing them as individuals.³⁴⁷

³⁴³ *Id.* at 348.

³⁴⁴ This is not true of revenues from sales to nonmembers, which under Bittker and Rahdert's approach would be subject to tax, and which are in fact taxable in the case of some kinds of mutual benefit organizations under current law. Bittker & Rahdert, *supra* note 90, at 350–52 (receipts from nonmembers generally taxable in the case of social clubs and consumer cooperatives); *id.* at 352–53 (exemption of receipts from nonmembers in the case of various other mutual benefit organizations and some cooperatives “probably reflects benign neglect more than thoughtful attention”).

³⁴⁵ *Id.* at 348–49.

³⁴⁶ Bittker & Rahdert, *supra* note 90, at 349–50.

³⁴⁷ Hansmann does not address Bittker and Rahdert's theory that the investment income of mutual benefit organizations should be taxed. Perhaps this is because their position on

3. Hansmann's Critique

Hansmann's basic position on mutual benefit organizations is that their exemption is to be assessed in terms of the capital-formation criterion discussed above in connection with altruistic nonprofits. If they arise in contexts where contract failure is a problem, then they are likely to be the most efficient suppliers and yet, owing to the constraints on their access to equity capital, they are not likely to be able to expand at an optimal rate. Under these conditions, mutual benefit organizations warrant the exemption of their net revenues from taxation as a means of increasing their retained earnings available for growth.³⁴⁸

But, as Hansmann points out, some mutual benefit organizations—social clubs, for example—arise in industries not beset by contract failure and provide their members essentially private goods that are available from alternative for-profit suppliers. These mutual benefit organizations fall outside the capital-formation rationale for tax exemption. With respect to them, Hansmann concedes that Bittker and Rahdert's exemption argument has some force. Recasting their theory slightly, Hansmann agrees that, at one level of analysis:

Since we do not tax individuals on household production that they use directly for their personal consumption, such as leisure activity and home-grown vegetables, it is inconsistent to levy a tax on the proceeds resulting when individuals band together, in a nonprofit or a cooperative corporation, to produce services for themselves.³⁴⁹

To treat the two similar forms of production differently for tax purposes would create artificial, and perhaps inefficient, incentives in favor of household production.³⁵⁰ But, Hansmann points out, an equally apt analogy between for-profit firms and mutual benefit organizations suggests a diametrically opposed result:

[I]t is not immediately apparent that there is a principled reason for imposing a tax on the return to capital in a tennis club in which the investors of capital and the customers are different people (as is likely to be the case if

investment income is a corollary to their position on exempt function income, which he finds fundamentally flawed.

³⁴⁸ Hansmann, *supra* note 68, at 93–94.

³⁴⁹ *Id.* at 95.

³⁵⁰ *Id.*

the club is formed as a business corporation), but not when the investors of capital and the customers are the same group of people (as is likely to be the case if the club is organized as a (mutual) nonprofit corporation or as a cooperative corporation).³⁵¹

Here again, Hansmann has caught Bittker and Rahdert in a dual fallacy. For one thing, they treat a factual feature—in this instance, the similarity between mutual benefit organizations and household production—as dispositive of a normative issue, whether mutual benefits should be tax exempt. This treatment could, of course, rest on a hidden but arguably accurate assumption, namely, that nonprofit production is like household production in the way that, as a policy matter, justifies the exemption of household production from the income tax. From this premise it would follow that, all other things being equal, production by mutual benefits should also enjoy tax exemption. As a matter of fact, however, household production is probably ignored for tax purposes because of measurement and monitoring problems that are not as serious in the context of mutual benefit organizations.³⁵²

Beyond that, all else is not equal. Even if mutual benefit organizations and household production share the feature that entitles the latter to tax exemption, mutual benefits nevertheless exhibit another feature that points to a different result. In Hansmann's view, this skewing additional feature is their similarity to for-profit production. Having found that production by mutual benefit organizations is like household production, which is tax exempt, and also like for-profit production, which is taxable, Hansmann has identified a dilemma. Moreover, as Hansmann points out, the resolution of the dilemma has practical repercussions: treating like forms of organization differently for tax purposes creates biases in favor of the more advantageously treated form. Finally, Hansmann implies, quite rightly, that the way out of the dilemma does not lie in the factual similarities themselves; these are the source of the dilemma, not its solution. His resolution is to use the bias of tax preference to offset the allocational bias he has identified, that is, the inaccessibility of equity capital to nonprofits addressing contract failure.³⁵³

³⁵¹ Hansmann, *supra* note 68, at 95–96.

³⁵² See M. CHIRELSTEIN, *FEDERAL INCOME TAXATION* 23–26 (5th ed. 1988) (noting theoretical, practical, and political problems of defining income to include imputed service income, or household production).

³⁵³ Hansmann, *supra* note 68, at 96.

But, as we have seen in connection with altruistic nonprofits, promotion of efficiency is not the only possible normative basis for exempting an organization's income. There I suggested that the structural differences between for-profit and nonprofit revenues—the availability of the former for distribution to equity owners, as opposed to the dedication of the latter to the benefit of others—could be taken as a substantive reason for exempting the income of nonprofits. One might prefer altruistic provision of goods and services, and decide to encourage organizations that engage in it with the exemption of their income from taxation. A similar argument can be made in the context of mutual benefit organizations. In addition to noting, as Hansmann does in his tennis club example, that nonprofit and for-profit suppliers differ essentially in the identity of those who receive the returns on their capital, one might decide, on grounds of public policy or private preference, that organizations operating to benefit their members should be given inducements unavailable to those operating to enrich their investors. In other words, mutualism, like altruism, could be viewed as a metabenefit to be encouraged with preferential tax treatment.³⁵⁴

C. *Unrelated Business Income of Altruistic Nonprofits*

Thus far we have examined the policy reasons for exempting exempt function, gift, and investment income, first of altruistic organizations, then of mutual benefit organizations. In this subsection we address separately the exemption of the fourth and final form of nonprofit income, unrelated business income. The principal reason for treating it separately is that, beginning in 1950³⁵⁵ and to an even larger extent after 1969,³⁵⁶ this form of income has been subject to tax irrespective of the exemption status of the recipient organization.³⁵⁷ The twin foci of the often elliptical debate about the unrelated business income tax are efficiency and fairness. No clear consensus has emerged on either point.³⁵⁸

³⁵⁴ See F. GLADSTONE, *supra* note 80, at 87–89 (urging treatment of mutual aid and self-help organizations as charities under United Kingdom tax system). I will not explore the merits of mutualism further, though some of what I say in defense of altruism in notes 362–79 and accompanying text, *infra*, is applicable to mutualism, *mutatis mutandis*.

³⁵⁵ Revenue Act of 1950, ch. 994, § 301, 64 Stat. 906, 947–53.

³⁵⁶ Tax Reform Act of 1969, Pub. L. No. 91–172, § 121, 83 Stat. 487, 568–84.

³⁵⁷ I.R.C. § 511 (1988).

³⁵⁸ Hansmann suggests that the existing system of taxing unrelated business income is fundamentally sound on efficiency grounds. Hansmann, *supra* note 15. Susan Rose-Ackerman has concluded that the tax in its present form creates more inefficiency—and unfairness—

My altruism account offers little on the former point beyond a cautionary note: even if the efficiency point is resolved in favor of the tax, other normative issues remain to be addressed before the debate is closed. One of these is whether exemption might nevertheless be an appropriate means of subsidizing the work of some or all altruistic organizations, even at some cost in efficiency. Resolution of that question, in turn, requires renewed focus on the fairness issue: even if one thought indirectly subsidizing certain nonprofits through the exemption of their unrelated business income were a good idea, would it be fair to deny the exemption to for-profits engaged in producing the same good or service?

The answer to this question lies, alas, beyond the scope of this paper, and perhaps also beyond my ethical insights. There is, however, a hidden premise in one form of the unfairness argument that can be readily—and briefly—revealed. Reduced to its essence, the argument runs like this:

- (1) Major premise—It is unfair to treat like organizations differently, such as by granting tax exemption to one but not another.
- (2) Minor premise—For-profit and nonprofit producers of widgets are alike in that they produce and sell widgets.
- (3) Conclusion—To grant tax exemption only to nonprofit widget producers would be unfair.³⁵⁹

The problem with this syllogism lies in its second premise, which silently assumes that a single asserted likeness, here the common production of widgets, is the only relevant characteristic. This may,

than it corrects, and thus she advocates its abolition. Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 STAN. L. REV. 1017 (1982). Traditional subsidy theory has tended to track the law itself. It once defended exemption of charities' unrelated income as destined for charitable purposes; it now tends to concede that such exemption would lead to "unfair competition" with for-profits. See, e.g., Stone, *supra* note 291, at 40-41, 51-52; see also F. GLADSTONE, *supra* note 80, at 86 (similar view of charities in United Kingdom). Bittker and Rahdert discuss the imposition of the tax on unrelated income as one of several recent retreats from full exemption and criticize it on a variety of economic and tax policy grounds, Bittker & Rahdert, *supra* note 90, at 319-26, relying in part on the analysis of Klein, *Income Taxation and Legal Entities*, 20 UCLA L. REV. 13, 61-68 (1972).

³⁵⁹ See Bennett & Rudney, *supra* note 286, at 1095:

The tax status of income-producing activities of nonprofits should be based on the fundamental principle and Constitutional guarantee of "equal treatment under law." . . . Commercial activities of nonprofits are carried on in the marketplace in competition with taxpaying firms. There is no justification for subsidizing such private market activity by treating the entity's commercial activity as tax free.

of course, be true. But sometimes it is not, as the following argument of the same form suggests:

- (1) Major premise—It is unfair to treat similar individuals differently, as by taxing some at higher rates than others.
- (2) Minor premise—High income individual taxpayers and low income individual taxpayers are all individuals.
- (3) Conclusion—Taxing high income taxpayers at higher rates is unfair.

This latter syllogism, for all its formal correctness, may be questioned nonetheless. An equally logical, and at one time politically respectable, argument reaches a radically different conclusion on the assumption that wealthy taxpayers' wealth itself has a significant bearing on the rate at which it is fair to tax them.

A parallel shift in premises gives a different conclusion in the UBIT debate as well:

- (1) Major premise—It is sometimes fair to treat different organizations differently, as by publically subsidizing one that provides a desirable good or service that the other does not provide.
- (2) Minor premise—In addition to producing widgets, altruistic nonprofits, but not for-profit organizations, provide the metabenefit of altruism.³⁶⁰
- (3) Conclusion—Altruistic nonprofit widget makers may fairly be granted tax exempt status that is denied to for-profit producers.

This argument, of course, is hardly above challenge itself. One might well question, for example, whether altruistic provision of goods and services is socially desirable.³⁶¹ And even if one takes the premises as true, the syllogism only proves that abolishing the unrelated business income tax would be fair, not that it is desirable. As with the question of progressive income taxation, allocative and incentive effects cannot be ignored. We must turn to these questions

³⁶⁰ Directly, in the case of Type 5 organizations like Hansmann's shoe store, where net gains are used to subsidize shoe consumers, or indirectly, as in the case of Type 4 organizations like NYU's macaroni factory, where net profits from the sale of one product are used to cross-subsidize consumption of another.

³⁶¹ As James and Rose-Ackerman point out, "we must acknowledge that the concept of 'equity' is highly subjective. All people would not agree on whether the income distribution is made better or worse after cross-subsidization by NPO's [nonprofit organizations]." E. JAMES & S. ROSE-ACKERMAN, *supra* note 8, at 91. My purpose here is not to resolve that issue, but to pose it more clearly.

of altruism's inherent desirability and attendant costs in the final subsection.

D. Altruism as a Metabenefit to Be Subsidized

This subsection, I am afraid, is bound to be something of an anticlimax. In section III, I identified nine kinds of organizations that embody a recognizable form of altruism ignored by the contract failure theory of nonprofits, and in section IV I showed that altruistic organizations address critical problems with individual altruism, problems that neither for-profit firms nor governmental entities can fully solve. In the preceding parts of this section, I formally analyzed altruism as a metabenefit that is the essential characteristic of altruistic organizations and showed that granting such organizations favorable income tax treatment would not run afoul of the problems Hansmann raises with other exemption justifications. It would be logical for me here to prove that altruism really is a good thing and thus worthy of tax favors. But that is too ambitious. The most that I hope to do in this subsection is to suggest why I do not attempt this proof and to show what some of the costs will be if altruism is nonetheless taken as worthy of subsidy.

1. The Goodness of Altruism

Like responsible parenthood and apple pie, altruism has a certain presumptive appeal. Unfortunately, it is hard to place that appeal on a solid theoretical foundation. It may be possible to argue in favor of the altruistic provision of goods and services on instrumental grounds, as a means to some higher end. Hansmann, for example, has shown that some altruistic nonprofits provide goods and services more efficiently. Simon argues that one particular kind of altruistic organization, the private foundation, provides a greater degree of innovation than is likely to come in their absence from either for-profit firms or the government. Perhaps an argument could be constructed showing that all altruistic organizations serve to advance some recognized good like efficiency or innovation or, as traditional theory suggests, pluralism or diversity.

Kenneth Boulding has offered the outline of an instrumental defense of altruism that, if sustainable, would tend to undermine any efficiency-based attack on the tax exemption of altruistic organizations. Building on Schumpeter's analysis of the culture of capitalism, Boulding suggests that market economies may not be able to sustain the societies that produce them. The institutional frame-

work of market economies may have to be supported by grants, transfers that, unlike those of the market itself, do not involve a material *quid pro quo* to the transferor.³⁶² To the extent that this is true, the kinds of transfers in which altruistic organizations essentially engage would be preconditions of an efficiently-operating market, the desideratum of the normative side of economic analysis.

But even if uncompensated transfers are essential to a market economy, it does not necessarily follow that indiscriminate encouragement of organizations engaging in such transfers would be a boon to capitalism. Indeed, as Hansmann has suggested, such encouragement might be baneful because it might undermine another critical component of capitalist societies, the urge for personal aggrandizement. In view of this risk, "one might argue that a society based on a free enterprise economy must be ever vigilant to maintain the entrepreneurial ethic."³⁶³ Unless capitalism is truly a frail flower, however, the baneful or beneficial effects it would feel from any particular public policy toward altruistic nonprofits are probably negligible.

On a less grand scale, incidental effects of exempting altruistic organizations are more predictable. This extension of the tax exemption would necessarily promote the acknowledged metabenefit of pluralism, because altruistic provision of goods and services is an alternative to both market and governmental provision. The pluralism fostered by the exemption of all altruistic nonprofits, moreover, would be a step beyond the pluralism often associated with the charitable exemption in its present form. The emphasis there is on a pluralism of means, of different ways of undertaking purposes publicly recognized as worthy. The altruism theory would promote a pluralism of ends, of different visions of what purposes should be undertaken for the benefit of others. Under the altruism theory, the presumption would be that any activity carried on altruistically is worthy of encouragement through tax exemption. Altruists would thus be encouraged not only to find new ways to provide recognized public benefits like health care and education, but to define for themselves new public benefits. By accepting the altruistic provision of any good or service as presumptively good, the law would leave it to individual altruists to choose the particular products they think their fellows most need. Thus an inevitable byprod-

³⁶² K. BOULDING, *THE ECONOMY OF LOVE AND FEAR* 28 (1973) (citing J. SCHUMPETER, *CAPITALISM, SOCIALISM AND DEMOCRACY* (1942)).

³⁶³ Hansmann, *supra* note 129, at 525.

uct of implementing the altruism theory of the exemption would be a broader form of pluralism.

One might, of course, question whether that form of pluralism—or, indeed, any of the other ends that the exemption of altruistic organizations can be alleged to serve—is itself truly desirable. We come, directly or indirectly, to a basic question: what is ultimately good? I hope I will be forgiven for not attempting to answer that question here. Less modestly—and perhaps less forgivably—I must admit my suspicion that the question of inherent goodness may not be subject to proof, in the case of either altruism or other proposed desiderata. Behind Hansmann's efficiency analysis is an elaborate effort to show why efficiency is, if not the summum bonum, then at least a reasonable approximation in human affairs.³⁶⁴ Similarly, Simon's defense of private foundations in terms of their innovativeness rests explicitly on John Rawls's theory of justice.³⁶⁵ With respect to altruism, Robert Paul Wolff has demonstrated that regard for others' welfare, even for the welfare of society, is at least a possible and intelligible preference. But, as he admits, it is one thing to say something is a possible preference, and quite another to say that it should be preferred.³⁶⁶ I suspect that the latter issue is not a matter of logical proof, but of faith, of freely chosen values and visions.³⁶⁷

2. Counting the Costs of Altruism

I decline, therefore, to try to show that altruism is inherently good. But by reviewing some of the costs of supporting altruistic organizations with tax exemption, I hope to make the case for their tax exemption clearer, if not compelling.

a. *Loss of tax exemption for non-altruistic organizations*

Extending the federal income tax exemption to all altruistic organizations would not necessarily involve withdrawing the ex-

³⁶⁴ See R. POSNER, *THE ECONOMICS OF JUSTICE* (1981), especially chapter 4, "The Ethical and Political Basis of Wealth Maximization."

³⁶⁵ Simon, *supra* note 235, at 251.

³⁶⁶ R. WOLFF, *THE POVERTY OF LIBERALISM* 193-94 (1968).

³⁶⁷ One problem with this fideist refusal to argue the good of altruism is that it leaves my flanks open to those who assert that altruism is undesirable, a sign of weakness, rather than strength, of character. See, e.g., F. NIETZSCHE, *ON THE GENEALOGY OF MORALS* (W. Kaufmann & R. Hollingdale trans. 1967). Having admitted the vulnerability of my position to this line of attack, I will not consider it further. Instead, I will address the possible objections of those who, while valuing altruism in the abstract, might question the wisdom of promoting it in the form and by the means I recommend.

emption that some non-altruistic organizations—mutual benefit organizations, for example—now enjoy. The altruism theory adds a new basis for exemption that would take its place among others such as those offered by traditional subsidy theorists and by Hansmann. If the altruism theory displaces anything, it is faith in one truly legitimate basis for tax exemption. Under the altruism theory in its purest form, altruism would be a sufficient, but not a necessary, condition of tax exemption.

b. *Efficiency costs*

We have noted several times in passing the charge that nonprofits are in general less efficient producers than their for-profit counterparts, primarily because they lack the salutary supervision of ordinary investors with an economic incentive to ensure that costs are minimized. If this theory is true, then exempting the income of altruistic nonprofits from taxation would be encouraging production by inefficient suppliers, hardly on its face a good thing. I do not mean to explore the charge of inefficiency further here, much less to try to rebut it. I do, however, want to point to several mitigating factors.

First, as Hansmann shows, in industries characterized by the kinds of contract failure he identifies, for-profit firms may themselves be subject to greater inefficiencies. In such industries, nonprofits, even if they are without the discipline of ordinary investors, may nevertheless be the lesser evil or, more positively, the second best.

Second, in industries not marked by contract failure, harm in the form of lost efficiency in particular industries should be reduced by competition, either from other nonprofits or from for-profits. Even assuming that tax advantages allow nonprofits to dominate an industry, as proponents of the original unrelated business income tax purported to fear,³⁶⁸ monopolization is hardly an inevitable result. More likely, other nonprofits would enter the industry, driving producers' returns—and consumers' prices—toward competitive levels.³⁶⁹ Moreover, if nonprofit suppliers as a group operate

³⁶⁸ See, e.g., S. REP. NO. 2375, 81st Cong., 2d Sess., reprinted in 1950 U.S. CODE CONG. SERV. 3053, 3081 ("The problem at which the tax on unrelated business income is directed is primarily that of unfair competition."); H. REP. NO. 2319, 81st Cong., 2d Sess., reprinted in 1950 C.B. 380, 409 (same language as Senate Report); H. REP. NO. 413, 91st Cong., 1st Sess., reprinted in 1969 U.S. CODE CONG. & ADMIN. NEWS 1645, 1689 (referring to the "general problem of unfair competition resulting from the conduct of an unrelated trade or business").

³⁶⁹ See Thompson, *supra* note 33, at 135–36 (tendency of donors to seek most efficiently operated nonprofits).

so wastefully that the price they charge reaches the point at which for-profits can earn a market rate of return on their capital, non-profits should lose purchasers to either new or existing for-profit firms. Thus, in industries where both for-profits and nonprofits can co-exist—principally those industries that provide ordinary consumer goods and services—the former serve implicitly to discipline the latter. From a rather paradoxical perspective, the role of for-profit firms can be viewed as keeping their nonprofit counterparts in line.

But why tolerate—or worse, encourage—even this “efficiency gap”? The only reason I can offer is that altruism can be viewed as a competing value, requiring that a balance be struck to effect an acceptable tradeoff of one for the other. Such tradeoffs are hardly novel. At the level of particular goods, we must decide between knives and margarine; at the metalevel of analysis more directly relevant here, we debate trading allocative efficiency for distributive justice. I am simply suggesting that altruistic supply might be another value to be weighed against allocative efficiency.

c. Tax exemption as an appropriate means

But even if altruism is admitted to be a desirable value for which some degree of economic efficiency should be sacrificed, and even if altruistic organizations are a useful vehicle in its implementation, is the tax exemption of their income an appropriate means of encouragement? The issue of whether there is a better way is, once again, an issue we cannot resolve here. Any full consideration of that issue, however, should not lose sight of two points. In the first place, tax exemption does help those organizations on which it is bestowed; as Hansmann points out, it allows them to retain more earnings to use toward the purposes for which they were founded. The question, therefore, is not whether the exemption is helpful, but how much help in the form of tax exemption costs. Second, in looking for less costly alternatives, it must be borne in mind that the existing system enjoys a considerable legitimacy and the not negligible advantage of being essentially in place; any alternative, however attractive in the abstract, must pass the threshold test of political viability.

d. Administrative costs

One obvious cost to be considered in evaluating any change in the present exemption system, particularly any expansion, is the

cost of its administration. If the exemption is to be extended to all altruistic organizations, then a minimal requirement must be that altruistic organizations can be identified and policed at an acceptable cost. In section III, I took this requirement to heart and tried to define a form of altruism that could be identified in the various nonprofits I described not only in principle, but also in practice. Even if I have failed to provide a criterion that can serve as an administrable criterion for exemption status, I think my definition of weak altruism is useful in two ways. The first, and most limited, utility of that definition is to help identify what should at least be a marginal factor in deciding individual cases under present law. In some close tax exempt status cases like *Presbyterian and Reformed Publishing Company*³⁷⁰ and *Orton Ceramics Foundation*,³⁷¹ weak altruism is a factor that gives an objective basis for distinguishing for-profit competitors, even if that factor is not to be given dispositive weight. Second, and more generally, the definition of a form of altruism that is a possible candidate for tax subsidy opens rather than closes inquiry into whether difficulties in administering that definition are surmountable now in some cases, and whether they might not be eventually overcome with continued effort in other areas.

e. *Regressivity problem*

As we saw in Hansmann's critique of Bittker and Rahdert's technical definition theory, the beneficiaries of many organizations exempt under present law are well-to-do. Museums, performing arts organizations, and universities cater to considerably different social strata than does the Salvation Army. A general way to correct this perceived regressivity problem, I suggested earlier, would be to offset it with more progressivity in the tax system as a whole. A more fine-tuned approach, which is to a limited extent reflected today in the requirements of exemption under the residual charitable category of section 501(c)(3),³⁷² would be to require a redistributive element as a precondition of exemption of organizations engaged in particular activities. Though the recent trend has been away from such a redistribution requirement in most areas,³⁷³ and

³⁷⁰ 743 F.2d 148 (3d Cir. 1984).

³⁷¹ 56 T.C. 147 (1971).

³⁷² See *supra* note 335 for a further discussion of section 501(c)(3).

³⁷³ Simon, *supra* note 26, at 84-85. In England, by contrast, the appeal of a redistributive requirement seems to be enjoying something of a revival, at least at one end of the political

though such a requirement would add a condition extraneous to the basic criterion of altruism that I propose, the addition would not be fundamentally at odds with that criterion.

f. *Privilege and the power to allocate*

Even if the problem of regressivity is surmounted, or accepted, there is the related, and less tractable, problem of allocative power and its attendant social costs. With all donative nonprofits, and particularly with private foundations, the subsidy of the tax exemption strengthens institutions that are the creatures, if not the servants, of the wealthy and thus at least indirectly enhances their patrons' prestige and power to allocate societal resources. This in turn tends to confirm and perhaps strengthen old patterns of dominance on the one hand and old patterns of deference and dependence on the other. To those with a deep dislike of inequality, this is an obviously distasteful side effect of exemption.³⁷⁴

But if tax inducements to private philanthropy are in this respect a bitter pill, several considerations make it a somewhat easier pill to swallow. For one thing, the situation has arguably been improved by the passage of the private foundation rules, particularly the limitations on continued holdings of business operations and the prohibition of the more overt forms of political involvement. And the situation may still be further improved. A frontal assault on the deference problem would be to require that gifts over a certain size be anonymous. A less direct, but more ambitious, approach would be to inculcate in both philanthropists and their beneficiaries a genuine sense that the former are doing no more than their duty as social stewards and the latter receiving only their due as fellow human beings.

spectrum. See F. GLADSTONE, *CHARITY, LAW AND SOCIAL JUSTICE* (1982) (especially chapter 5, "Who Shall Benefit?," questioning legitimacy of charitable status of English "public" schools and private hospitals). And the trend away from a redistributionist requirement in this country has not gone unchallenged. See, e.g., *Eastern Kentucky Welfare Rights Org. v. Simon*, 506 F.2d 1278 (D.C. Cir. 1974) (challenge to I.R.S. reduction in amount of service to indigents required of hospitals seeking charitable exemption), *vacated on other grounds*, 426 U.S. 26 (1976).

³⁷⁴ See W. GAYLIN, I. GLASSER, S. MARCUS, & D. ROTHMAN, *DOING GOOD: THE LIMITS OF BENEVOLENCE* x (1978) (collection of essays addressing the recognition that "a claim once considered to be of the most virtuous sort, the claim to be acting benevolently, ha[s] become—to understate the point—suspect"); J. VAN TIL, *supra* note 1, at 63–67 (outlining a Marxist critique of voluntary organizations).

On a less optimistic note, however, there may be no alternative that produces the present level of donations. Deference may be the price of generosity; private power bases may be a cost that accompanies decentralized reform. And if private philanthropy is not a poison pill, it is hardly a panacea. Society will certainly not be radically transformed in the short run by the operation of altruistic nonprofits, whether or not their income is tax exempt. But even if more dramatic remedial measures—sharply progressive income taxation, truly redistributive transfer taxation, socialism itself—are much to be desired, they are certainly not soon to be achieved. Those who discount the evils of incrementalism and those who are resigned to them may be willing to settle for private philanthropy as part of the second best.

g. *Prohibitions of current law*

Section 501(c)(3) of the tax code now imposes two kinds of negative conditions on the activities of charitable organizations. First, section 501(c)(3) by its own terms forbids charities to engage in any political campaign activities and in more than an insubstantial amount of lobbying activities. Second, the United States Supreme Court has interpreted the congressional intent behind section 501(c)(3) to preclude the exemption of activities that violate fundamental public policies like the racial desegregation of education.³⁷⁵ Whatever the wisdom of these conditions,³⁷⁶ either could be continued without upsetting the basic notion proposed here, that altruistic organizations are generally entitled to tax exemption.

h. *Eccentric purposes*

We have seen that section 501(c)(3) in its present form, supported by the traditional subsidy theory, bases the tax exemption of charities on the supposedly salutary provision of particular products or the relief of recognized forms of need. The altruism theory, by contrast, takes the altruistic provision of any good or service as inherently desirable and *prima facie* worthy of encouragement through tax exemption. I have argued that, in addition to recog-

³⁷⁵ *Bob Jones University v. United States*, 461 U.S. 574 (1983).

³⁷⁶ On the political restrictions, see Clark, *supra* note 280 (political activity); on prohibition of activities in violation of public policy, see J. DOUGLAS, *supra* note 9, at 130; Galston, *Public Policy Constraints on Charitable Organizations*, 3 VA. TAX REV. 291 (1984).

nizing the inherent good of altruism, the latter approach also desirably decentralizes decision-making, encouraging donors and founders to exercise wide discretion in sowing the seeds of their altruism. It must be admitted, however, that there are risks in letting a thousand flowers bloom; in the field of the world, the danger is that the Evil One will plant tares among the lilies.

Under the common law of charitable trusts, which federal tax law explicitly tracks,³⁷⁷ purposes that are deemed impossible to accomplish or grossly eccentric have been denied charitable status.³⁷⁸ It could be argued that the permissiveness of the altruism theory threatens to remove this restriction and permit a luxuriant crop of useless, if not noxious, weeds to grow in the garden of charity. This problem is compounded, so the argument would run, by the fact that the lives of charities are unlimited; mutant charities should be chopped down before they take root, not allowed to go on bearing their insipid—or baneful—fruit forever. There are two responses to this argument.

The first is to dismiss the problem as relatively insignificant. To the extent that the organization sells its products at something approaching the market price, that alone is evidence that people want them; the only harm here is an arguably misplaced subsidy. The cost in terms of “wasted” resources may be greater in the case of nonprofits fully supported by donations, where consumer demand is wholly lacking. Yet even assuming that the particular purposes for which donors set aside resources are sometimes truly pointless, this dead loss must be counted against the more general gain of allowing individual diversity in the choice of altruistic objects. It can scarcely be denied that a similar tolerance for eccentricity is now indulged in the case of religious organizations as a corollary to the first amendment’s positive preference for free exercise and pluralism. Negatively—and still in the penumbra of the first amendment—it may be objected that the prevention of eccentric charitable purposes is worse than the disease.

The second response is to import something of the old policing mechanism into the new exemption criterion, but with an ear to the warnings sounded above. Like the restrictions on political activity and on activity that violates public policy, this can be seen as an

³⁷⁷ Treas. Reg. § 1.501(c)(3)-1(d)(2) (1985) (“The term ‘charitable’ is used in section 501(c)(3) in its generally accepted legal sense . . .”).

³⁷⁸ G. BOGERT, *supra* note 264, § 379, at 204-05; 4A A. SCOTT, *supra* note 258, § 374.7, at 229-31; RESTATEMENT (SECOND) OF TRUSTS § 374.7 (1959).

additional criterion implementing policy concerns essentially extraneous to the promotion of altruism. Here, however, there is a greater risk of sub rosa return to the traditional subsidy theory. As the list of useless purposes to be weeded out grows longer, it threatens to become a requirement that only certain favored purposes be allowed to thrive. Once the shears are in hand, all it takes is an overzealous gardener to carve the rambling vegetation of a country retreat into the strictly classical geometry of the topiary at Versailles.³⁷⁹

It may be that the various objections discussed in this subsection preclude using the weak altruism I have identified as an independent basis for federal income tax exemption. It may be too costly to identify and monitor; it may require too great a sacrifice of other values; it may need to be supplemented by other, essentially unrelated, criteria. Even so, identifying the altruistic provision of goods and services as a possible value and describing this phenomenon in a number of structurally different kinds of organizations, some of which closely resemble their for-profit competitors, should shift the terms of the debate on the proper scope of the exemption. It can no longer be said that certain nonprofits that produce the same good or service as counterpart for-profit firms are to be treated the same because there is no principled reason for treating them differently. In the face of such a reason—the asserted desirability of altruism—opponents of exempting altruistic organizations must argue either that altruistic provision is not inherently good or that the good comes at too great a cost in other values. To make either argument is implicitly to acknowledge the most basic premise of the altruism theory—that the debate over the scope of the tax exemption of nonprofits is at bottom a debate about values, less a disagreement about what the world is like than about what it ought to be like.

In discussing the proper scope of the federal tax exemption for altruistic nonprofits, we are engaged not so much in a voyage of discovery, as in an exercise of statecraft. The product will be more like the Pilgrims' Mayflower Compact than Vespucci's map. Having charted the nonprofit domain, we now need a charter of cooperation between the for-profit, nonprofit, and governmental spheres for the improvement of our common world. My purpose

³⁷⁹ See L. SIMES, *supra* note 267, at 133 (noting need to balance the elimination of eccentric purposes with the risk of destroying the pioneering spirit of charity).

has been to argue for a larger role for altruism in the world we must make.³⁸⁰

VI. CONCLUSION—TOWARD AN HERETICAL THEORY OF FOR-PROFIT FIRMS

We began with Hansmann's assumption that for-profit firms are the norm in our society's provision of goods and services. But "norm," as I noted there, is an ambiguous notion. It can have a merely descriptive function, denoting what is prevalent or predominant. In that sense, for-profit firms are—perhaps always will be—the norm in our society, and nonprofits' role may be merely derivative, as Hansmann's theory suggests. But "norm" has another, prescriptive sense, a sense that refers to what ought to be. In that sense nonprofit firms, and the altruism they embody, may be our norm. On this view, the invisible hand of the market, operating without regard to need, is not the ideal, but a necessary stopgap where the helping hand of altruism, implementing conscious concern for need, has not yet reached.

³⁸⁰ This is emphatically not to say that the design of that world should not borrow from the insights of neo-classical economics. But as Robert Paul Wolff reminds us in his critique of liberalism, the philosophical foundation of neo-classical economics, "It is shrewd of the philosophers of liberalism to insist that their world of private values is the only possible world." R. WOLFF, *POVERTY OF LIBERALISM* 194 (1968).

APPENDIX
TAXONOMY OF NONPROFIT ORGANIZATIONS

LOCUS OF BENEFIT	LOCUS OF CONTROL					MODE OF FINANCE	
	ENTREPRENEURIAL (Controllers ≠ Financers)			MUTUAL (Beneficiaries ≠ Financers)		DONATIVE	COMMERCIAL
	Controllers ≠ Financers ≠ Beneficiaries	Beneficiaries = Financers	Controllers = Beneficiaries	Beneficiaries ≠ Financers	Beneficiaries = Financers		
	TYPE 1- Donative Entrepreneurials Not FBO (for benefit of) Donors	TYPE 2- Donative Entrepreneurials FBO Donors	TYPE 3- Donative Entrepreneurials Controlled by Beneficiaries	TYPE 4- Donative Mutuals Not FBO Donors	TYPE 5- Donative Mutuals FBO Donors		
	TYPE 6- Commercial Entrepreneurials Not FBO Patrons	TYPE 7- Commercial Entrepreneurials FBO Patrons	TYPE 8- Commercial Entrepreneurials Controlled by Beneficiaries	TYPE 9- Commercial Mutuals Not FBO Patrons	TYPE 10- Commercial Mutuals FBO Patrons		