

Altruism, Nonprofits, and Economic Theory

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IN RECENT DECADES economists have begun to reexamine the psychological and organizational premises of their discipline. The result is a greater willingness to consider activities formerly viewed as outside the field, such as selfless individual behavior or mass political action, and a growing effort to analyze “noneconomic” institutions like churches, clubs, political parties, and charities. Altruism and nonprofit entrepreneurship cannot be understood within the standard economic framework. Theoretical progress requires a richer conception of individual utility functions and a base in cognitive psychology that incorporates the power of ideas and emotions in motivating behavior. The economics of organizational form is producing new models of institutional behavior. Research on the voluntary or nonprofit sector is part of this ongoing effort.

As the study of nonprofits has developed and the data base has grown, analytic efforts that preserve sharp distinctions between the for-profit, nonprofit, and public sectors look increasingly problematic. Many nonprofits receive substantial resources from public

sources. Others engage in profit-making activities. For-profit firms make charitable donations, and industries such as nursing homes and child day care have large numbers of both nonprofit and for-profit providers. Altruism does not require the creation of a nonprofit organization, and conversely, many nonprofit institutions receive minimal private donations of money and time. Similarly, ideological commitment is not tightly linked to nonprofit creation. Ideologues may go into politics rather than set up a nonprofit organization; many for-profit entrepreneurs have a deep commitment to the goods and services they produce; and some nonprofits are run on profit-maximizing principles. Conversely, even if all people were narrow egoists, nonprofit firms might still survive in the marketplace.

Yet differences persist. The impact of organizational form on firm performance and survival depends upon the interaction between institutional structure and other features of the environment such as entrepreneurial motivations, private donations, government policies, and the overall competitive environment. No organizational form is invariably superior,

but one can isolate factors that will favor one form over another. For reasons to be outlined below, donations to organizations are mostly given to the nonprofit sector, and I will argue that nonprofits retain a special advantage for some types of ideological entrepreneurs. Furthermore, the lack of equity owners with a claim to profits can be an advantage for providers of certain difficult-to-evaluate services.

To set the stage, the first two sections survey data on private donations and on the size of the organized nonprofit sector and summarize work on the economics of altruism. The third section outlines the economic function of nonprofit organizations emphasizing the links between altruism, organizational form, and market structure. Organizations may operate differently depending upon their ownership structure and upon the motivations of employees, managers, and customers. Yet competitive market pressures exist even when the firms are nonprofits and individuals are altruistic. Thus the next section explores the role of competition between nonprofits and for-profits in industries where both types persist over time. The final section reviews the empirical evidence on the relative performance of nonprofits, and the conclusion summarizes my argument and draws some lessons for the regulation of the nonprofit sector.

1. *Private Giving and the Nonprofit Sector—Basic Facts*

The nonprofit sector is not primarily financed by private gifts and is not focused on aiding the poor and needy (Weisbrod 1988; Clotfelter, ed. 1992). Conversely, not all altruism requires an organizational base. Friends, neighbors, and family members help each other, and strangers benefit from the spontaneous Good Samaritan efforts of others

(Virginia Hodgkinson and Murray Weitzman 1994, pp. 23–24). Psychological studies of helping behavior confirm the importance of altruism in everyday life (Jane Allyn Piliavin and Hong-Wen Charng 1990; Kristen Renwick Monroe 1994). However, because the aim of this review is to understand the role of nonprofit firms, I focus only on donations of money and time to organizations. Annual data released by the IRS permits a rough measure of this type of giving. Because not all taxpayers itemize their donations, the IRS data must be supplemented with estimates of the giving of nonitemizers who are mostly low-income people.¹

Independent Sector estimated that total monetary contributions in 1990 were \$122.6 billion. Of the total, \$109.6 billion or almost 90 percent was personal giving.² Most monetary donations are given to charitable nonprofit organiza-

¹ Overall estimates of monetary donations are made annually by the American Association of Fundraising Councils (AAFRC) based on a model developed by Ralph Nelson (1986). The Independent Sector (IS) produces periodic estimates of the amount of volunteer labor. Both the AAFRC data and IS's own estimates are reported in Hodgkinson et al. (1992). The most recent IS estimates are in Hodgkinson and Weitzman (1994).

The institutions that fall under sections 501(c)(3) and 501(c)(4) of the Internal Revenue Code are included in the "Independent Sector" by the umbrella organization, Independent Sector. The 501(c)(3) category includes organizations "organized for charitable or mutual benefit purposes." They can accept gifts that are tax deductible for donors. The category includes organizations that have religious, charitable, scientific, testing for public safety, literary, or educational purposes. To qualify, organizations must assure that no part of their net earnings inures to private shareholders or individuals, and that they do not engage in political activity. Those registered as 501(c)(4) organizations are tax exempt, but gifts to such organizations are not tax deductible to donors (Commerce Clearing House 1983, section 501, p. 181; Hodgkinson et al. 1992, p. 189).

² Personal giving from living donors was \$101.8 billion and bequests totaled \$7.8 billion. The remainder was accounted for by foundations \$7.1 billion (5.8%), and gifts from corporations \$5.9 billion (4.8%) (Hodgkinson et al. 1992, table 2.2, p. 60).

TABLE 1
HOUSEHOLD CONTRIBUTIONS BY TYPE OF CHARITY: 1993 (IN CURRENT DOLLARS)

Type of Charity	Percentage of Total Respondents	Average Contribution per Contributing Household (Dollars)	Average Contribution per Household (Dollars)	Percentage of Total Contributions
Arts, culture, and humanities	8.1%	\$139	\$11	1.7%
Education	17.5	424	74	11.5
Environment	11.6	89	10	1.5
Health	25.7	139	36	5.6
Human Services	26.7	208	56	8.7
International, foreign	2.8	*	*	*
Other	4.7	81	4	0.6
Private/community foundations	5.3	144	8	1.2
Public/societal benefit	11.2	160	18	2.8
Recreation-adults	4.6	193	9	1.4
Religious organizations	49.2	817	402	62.2
Youth development	17.9	106	19	2.9
Total	73.4%	\$880	\$646	100.1%**

Source: Hodgkinson and Weitzman, (1994, table 1.3). For a description of the study methodology see the original source.

* Not enough unweighted cases.

** Totals do not add to 100.0 due to rounding.

Question: To which, if any, of these fields have you or the members of your family or household contributed some money or other property in 1993?

tions. However, IS estimated that 14.7 percent of household contributions in 1989 went to for-profit organizations and governments, mostly localities. (For-profits received 2.5% and governments 12.2%; Hodgkinson et al. 1992, table 2.5, p. 64.) In 1993 the value of volunteer labor provided to organizations was an estimated \$182.3 billion according to IS.³

³ This is a rough estimate of the dollar value of the 19,481.3 million hours spent volunteering in organizations (Hodgkinson and Weitzman 1994, table 1.5, p. 23). The IS estimates the opportunity cost of volunteers' time using the average nonagricultural hourly wage plus 12 percent for fringe benefits. The total may over- or understate the cost to the organization of substituting paid for volunteer labor (Weisbrod 1988, p. 133; Steinberg 1990b, pp. 164-66). The IS data include volunteering in firms and government. In 1989, 68.3% of volunteer hours were donated to nonprofit organizations, 5.6% to for-profits, and 26.1% to governments, mostly local public schools (Hodgkinson

According to the same source, monetary donations were 1.7 percent of household income in 1993 or \$646 per household (Hodgkinson and Weitzman 1994, table 1.1, p. 16). Corporate contributions totaled 1.82 percent of pretax income or 3.48 percent of after tax income in 1989 (Hodgkinson et al. 1992, table 2.41, p. 103). Table 1 summarizes the results of a survey sponsored by IS showing the distribution of household contributions across sectors. Religion was the most important category, receiving over 60 percent of household giving in 1993.

Total resources available to the independent sector in 1992 were an esti-

et al. 1992, table 2.6, p. 65). Applying this percentage distribution to 1993 yields \$114.6 billion as the value of volunteer labor given to nonprofits.

TABLE 2
INDEPENDENT SECTOR: SOURCES OF ANNUAL FUNDS BY SUBSECTOR, 1992
(IN PERCENTAGES)

		Annual Sources of Funds								
SIC ¹ Code	Subsector	Private Contri- butions	Payments		Other Receipts				Total Funds (1)+(4)+(8)	
		Total	Private Sector	Govern- ment Sector	Total	Endowment, investment income	Church	Other		
		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
80	Health services	3.6	48.3	40.7	89.0	2.5	1.9	3.0	7.4	100.0
82,873	Education/research	12.7	57.0	20.0	77.0	5.3	2.6	2.4	10.3	100.0
866	Religious organizations ²	94.5	6.7	—	6.7	2.2	-13.7	10.3	-1.2	100.0
81,83	Social and legal services	20.0	17.5	50.0	67.6	2.7	0.5	9.1	12.3	100.0
864	Civil, social, and fraternal organizations	31.3	20.4	33.3	53.7	2.0	0.7	12.2	15.0	100.0
483,792,84	Arts and culture	40.2	24.4	14.7	39.1	9.8	1.2	9.8	20.7	100.0
6732	Foundations ³	-57.0	45.5	—	45.5	50.6	0.5	60.9	111.5	100.0
	Unallocated	<u>100.0</u>	=	=	=	=	=	=	=	<u>100.0</u>
	Total	18.4	39.1	31.3	70.4	4.6	0.0	6.6	11.1	100.0

Source: Unpublished data to be included in a forthcoming publication in 1996. Independent Sector, Washington, D.C. The table is an updated version of Table 4.3 in Hodgkinson et al. 1992. See that source for detailed definitions.

¹Standard Industrial Classification.

²Religious organizations both receive contributions and provide them to other organizations of the independent sector. To present net estimates for the independent sector and to estimate the sacerdotal activities of religious organizations, adjustments are made in the receipts for the religious organization that shows the estimated amount of money subtracted for use on nonsacerdotal activities.

³Foundation contributions to the various subsectors of the independent sector are included in the rows in the private contributions column, which is why these contributions show up as a negative estimate for foundations. Estimates placed in the cells for payments from the private sector represent contributions to foundations. Such estimates are not included in column totals for private sector payments but are added to the totals for the private contributions column. Foundations essentially are tax-exempt financial institutions engaged in receiving, investing, and distributing funds to organizations of the independent sector, to government institutions such as public universities, and to individuals. In order to avoid counting both the receipt and the distribution of foundation funds in the overall assessment of the total funds for the independent sector, the net contribution of foundations to the independent sector is estimated by adding contribution of foundations to endowment and subtracting the grants of foundations to the independent sector from total receipts of foundations.

mated \$508.5 billion, not counting the value of volunteer labor. Private sector monetary donations were 18.4 percent of sector resources. The balance came from the government (31.8%) and from charges, dues, and investment

income (50.2%).⁴ Including the value of volunteer labor as estimated by IS,

⁴Independent Sector data. If the value of volunteer labor (\$110.8 billion) is included, then the share of private donations in the total rises to 33%.

the independent sector accounted for 6.5 percent of national income and 10.6 percent of employment in 1992.⁵

As Table 2 demonstrates, there is wide variation in the proportion of resources accounted for by private donations, fees and charges, and government support. In 1992, health care, the sector with the largest share of nonprofit revenues, had the smallest reliance on private donations of any of the major sub-sectors—3.6 percent. It is financed mostly by public and private fees. No service-providing category obtained more than half of its resources from private donations.

The independent nonprofit sector is growing. Excluding the imputed value of volunteer labor, the sector grew from 3.0 percent of national income in 1977 to 3.8 percent in 1990 and from 5.3 percent to 6.3 percent of paid employment (Hodgkinson et al. 1992, tables 1.4, 1.5, pp. 27–29). A study of the birth of new institutions using IRS data suggests that economic conditions affect overall levels of nonprofit formation, but that government policies, philosophical fads, and “field saturation” helped determine the relative entry rates of different sectors (Bowen et al. 1994, pp. 50–64). Contrasting 1965–1975 with 1975–1988, the authors distinguished three groups of charities. “Old enthusiasms” (arts\culture, education, health, employment, human services, and animal services) experienced a dramatic slowdown in institutional births between the two periods; “new enthusiasms” (science\technology, community improvement) experienced

⁵ Excluding volunteer labor, the percentages are 4.3% and 6.6% respectively. Independent sector workers were 8.4% of employees on *non-agricultural* payrolls according to Bureau of Labor Statistics figures (Data are from a forthcoming publication of Independent Sector by Virginia Hodgkinson and Murray S. Hodgkinson).

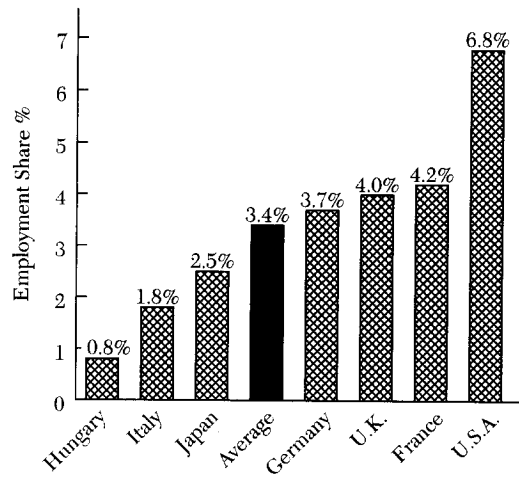


Figure 1. Nonprofit Sector Employment as Percentage of Total Employment

Source: Johns Hopkins Comparative Nonprofit Sector Project, Salamon and Anheier (1994, p. 32).

rapid growth in the second period compared with the first, and “continuing enthusiasms” (conservation\environment, international affairs, recreation\leisure) had relatively constant birthrates.

The relative importance of public funds, private gifts, and fees or charges differs across countries. Nowhere is private charity so important as in the United States. In most European countries nonprofits are heavily dependent on public money, although fees and charges are also important in some areas. The Johns Hopkins Nonprofit Sector Project has documented these differences in studies based on a consistent definition of the sector (Lester M. Salamon and Anheier 1994). Figures 1, 2, and 3 summarize their results for 1990. Because of somewhat different definitions, the data for the United States are not completely compatible with the Independent Sector’s data, but the broad pattern is similar. Among the Western European countries included in the study, the nonprofit sector is remarkably similar in size, but only in the United Kingdom are private donations an important source of

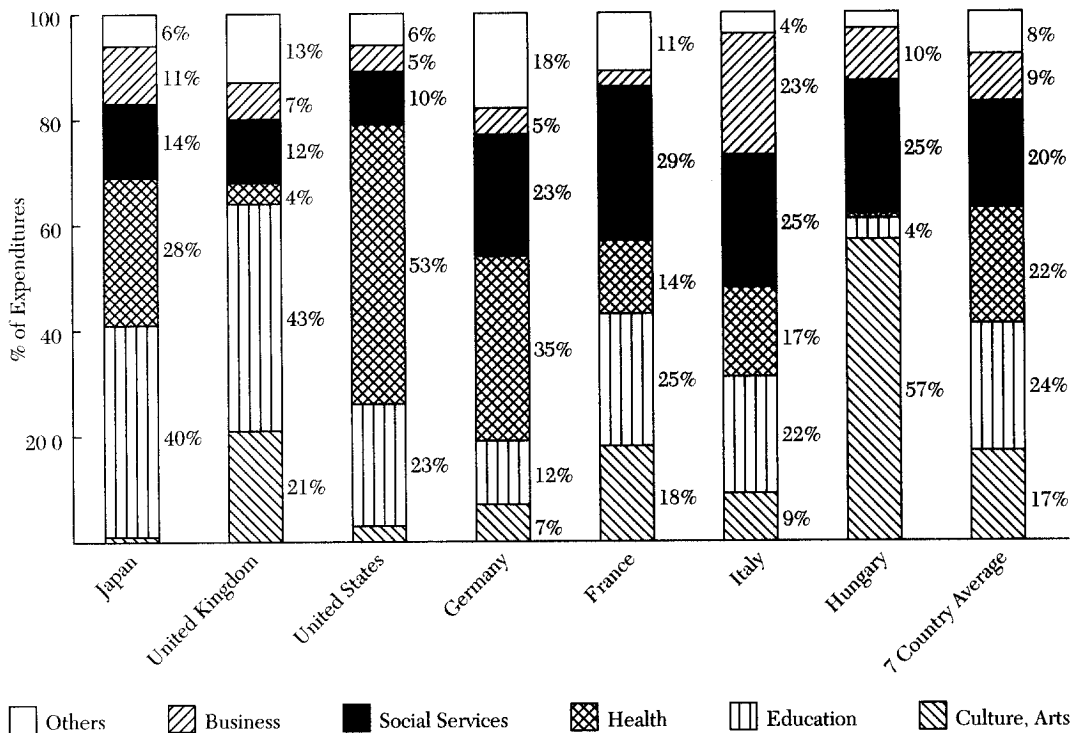


Figure 2. Composition of the Nonprofit Sector

Source: Johns Hopkins Comparative Nonprofit Sector Project, Salamon and Anheier (1994, p. 45).

funds.⁶ Health care is especially dominant in the United States, but this is a sector where private donations are relatively unimportant. Germany also has a large number of nonprofit hospitals financed mainly by payments from the national health care system. Education and research are particularly important in the United Kingdom and Japan and are financed largely by fees and government

⁶ The study, however, omits religious organizations. Only Hungary reports a mix of funding sources similar to the United States. Its sector, however, is a much smaller share of GDP than in the United States, and the development of the nonprofit sector has been heavily influenced by private gifts originating outside the country. Furthermore, the fee portion of revenues is apparently mainly from enterprises that may not themselves have a charitable character but that are owned by nonprofits. See Salamon and Anheier (1994, pp. 89-90).

grants. Germany, in contrast, has few private educational institutions. The differences in the distribution of nonprofit activity across countries reflects the greater role of the state in providing social services, health care, and education in Europe and Japan compared to the United States. The data also reflect differences in government attitudes toward the creation of nongovernmental organizations that could be a source of opposition to official policies.

Many sectors of the U.S. economy include a mixture of organizational forms. Some, such as elementary and secondary education, are dominated by public and nonprofit entities. Others, such as arts and culture, are provided mainly by for-profit and nonprofit firms. Still others contain a mixture of all three forms.

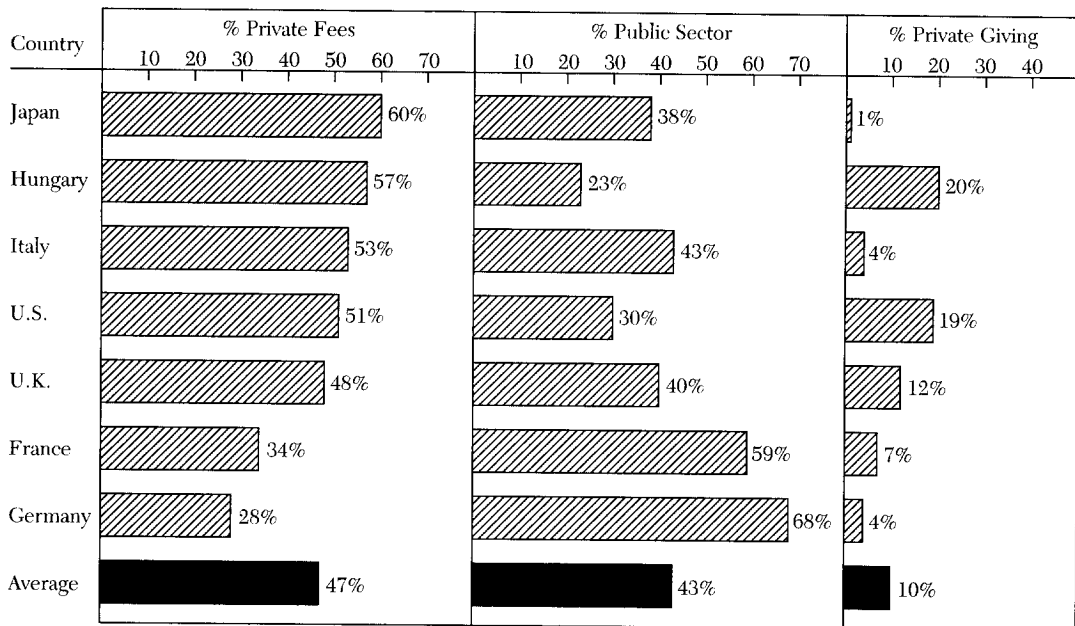


Figure 3. Sources of Nonprofit Revenue, by Country

Source: Johns Hopkins Comparative Nonprofit Sector Project, Salamon and Anheir (1994, p. 61).

Hospitals, nursing homes, child day care, and research, are provided by a rich variety of organizations that have coexisted over several decades. Although the relative shares have changed over time, no type appears to be withering away. Tables 3, 4, and 5 summarize data on industries where private nonprofits coexist with other types of organizations. Table 3 presents material on for-profits and nonprofits from the 1987 Census of Service Industries. Organizations with affiliations to religious organizations are not included. Government providers are omitted except in the hospital sector where they are included in the tax exempt column. Table 4 collects material on the distribution of organizational forms from various sources.⁷

⁷ Taken together these tables provide an overview of the relevant service industries, but they contain some inconsistencies. For example, the Census of Service Industries indicates that child day care is more dominated by taxable firms than

Table 5 demonstrates that for most sectors where taxable and tax-exempt firms coexist, both parts of the industry have grown in recent years. In some sectors, such as child day care and job training, the rate of growth of the taxable sector is much more rapid than the growth of the tax-exempt portion. Others, such as hospitals, are more

does the source cited in table 4. Since the number of taxable firms is similar in both sources, the difference comes from the Census' omission of over 20,000 nonprofits. The Census excludes 11,424 religious-sponsored centers and Head Start programs run by nonprofits (Ellen Eliason Kisker et al. 1991). The distribution of Head Start centers comes from the U.S. Department of Health and Human Services (1994). Another puzzle is the number of psychiatric hospitals. The American Hospital Association counts 354 in 1991 and the 1987 Census finds 787, a huge increase over 1977 when the total was 214. This divergence may, in part, be a difference in the definition of a hospital, with the Census counting as different establishments entities that are grouped together by the AHA.

TABLE 3
 SERVICE INDUSTRIES WHERE TAXABLE AND TAX-EXEMPT FIRMS COEXIST
 TOTAL U.S. ESTABLISHMENTS WITH PAYROLL, 1987

SIC Codes	Industry	Taxable	
		Number	Receipts ¹ \$1,000
Health:			
8051	Skilled nursing care facilities	9,482	16,938,103
8052	Intermediate care facilities	2,407	2,190,524
8059	Nursing and personal care facilities, n.e.c.	1,526	934,132
8062	General medical and surgical hospitals ³	885	15,891,443
8063	Psychiatric hospitals ³	373	2,929,743
8069	Other specialty hospitals ³	137	898,745
808	Home health care services	5,080	3,023,896
8092	Kidney dialyses Centers	711	824,694
8093	Specialty outpatient facilities, n.e.c.	5,287	2,949,012
8099	Health and allied services, n.e.c.	3,502	1,655,959
Legal:			
81	Legal services	138,222	66,997,543
Education:			
823	Libraries	178	32,663
824	Vocational schools	3,702	3,058,342
829	Schools and educational services, n.e.c.	6,716	1,791,393
Social Services:			
832	Individual and family social services	4,519	728,555
833	Job training and vocational rehab. serv.	1,777	795,020
835	Child daycare services	26,809	2,943,823
836	Residential care	8,516	2,489,808
839	Social services, n.e.c.	1,450	372,966
Other:			
7032	Sporting and recreational camps	1,729	472,271
7922	Theatrical producers, and misc. services	3,253	2,543,391
7929	Bands, orchestras, actors & other entertainment groups	4,594	2,360,833
7997	Membership sports and recreation clubs	7,659	3,699,831
7999	Fairs	164	46,390
873	Research, development and testing services	12,390	14,184,178
874	Management and public relations services	60,501	35,113,851

Source: U.S. Department of Commerce (1987). Detailed definition of industry categories and other terms are available in Appendix A of the source.

¹ Includes receipts from customers or clients for services rendered, from the use of facilities, and from merchandise sold during 1987 whether or not payment was received in 1987, except for health practitioners and legal services, which reported on a cash basis (payments received in 1987 regardless of when services were rendered). Excise taxes on gasoline, liquor, tobacco, etc., which are paid by the manufacturer or wholesaler and passed on in the cost of goods purchased by the service establishment, are also included. Receipts from leasing of vehicles, equipment, etc. marketed under operating leases are included in receipts figures as well as the fair sales value of merchandise marketed in 1987 under capital, finance, or "full payout" leases. Receipts also include the total value of service contracts, amounts received for work subcontracted to others and dues and assessments from members and affiliates.

(TABLE 3 cont'd.)
 SERVICE INDUSTRIES WHERE TAXABLE AND TAX-EXEMPT FIRMS COEXIST
 TOTAL U.S. ESTABLISHMENTS WITH PAYROLL, 1987

SIC Codes	Industry	Tax-exempt		Tax-exempt share in %	
		Number	Revenues ² \$1,000	Number	Revenue
Health:					
8051	Skilled nursing care facilities	2,331	6,615,234	20	28
8052	Intermediate care facilities	1,353	1,215,336	36	36
8059	Nursing and personal care facilities, n.e.c.	426	370,874	22	28
8062	General medical and surgical hospitals ³	5,121	155,253,436	85	91
8063	Psychiatric hospitals ³	414	8,270,194	53	74
8069	Other specialty hospitals ³	368	8,471,249	73	90
808	Home health care services	1,769	2,103,309	26	41
8092	Kidney dialyses Centers	128	201,092	15	20
8093	Specialty outpatient facilities, n.e.c.	3,757	2,530,681	42	46
8099	Health and allied services, n.e.c.	1,082	1,147,872	24	41
Legal:					
81	Legal services	1,439	665,366	1	1
Education:					
823	Libraries	1,392	379,957	89	92
824	Vocational schools	846	361,231	19	11
829	Schools and educational services, n.e.c.	2,490	1,012,118	27	36
Social Services:					
832	Individual and family social services	21,862	8,585,174	83	92
833	Job training and vocational rehab. serv.	5,005	3,663,736	74	82
835	Child daycare services	13,822	2,233,489	34	43
836	Residential care	10,474	6,125,174	55	71
839	Social services, n.e.c.	11,839	10,944,392	89	97
Other:					
7032	Sporting and recreational camps	1,117	254,362	39	35
7922	Theatrical producers, and misc. services	1,151	797,047	26	23
7929	Bands, orchestras, actors, & other entertainment groups	981	1,004,474	18	30
7997	Membership sports and recreation clubs	6,549	3,693,675	46	50
7999	Fairs	512	269,341	78	85
873	Research, development, and testing services	3,165	8,303,463	20	37
874	Management and public relations services	814	902,416	1	3

²Includes revenue from customers or clients for services rendered and merchandise sold during 1987, whether or not payment was received in 1987. Also included are income from interest, dividends, gross contributions, gifts grants (whether or not restricted for use in operations), rents royalties, dues and assessments from members and affiliates, and net receipts from fundraising activities. Receipts from taxable business activities of firms exempt from federal income (Unrelated Business Income) are also included in revenue.

³Government hospitals are included in the data for the tax-exempt sector.

TABLE 4
SECTORAL COMPOSITION BY INDUSTRY

Industry	Service	Units date	Total	Nonprofit share in %	For-profit share in %	Public share in %
Healthcare	Short stay hospitals	Establishments, 1991	5,675	56	13	31
		Beds, thousands, 1991	12.6	66	10	25
	Psychiatric hospitals	Establishments, 1991	354	11	21	67
		Beds, thousands, 1991	121.1	3	6	91
	HMOs	Enrollees, 1993		48	52	0
	Homes for mentally handicapped	Residents, 1976		38	46	16
	Blood banks	Facilities, 1976		6	63	31
	Dialysis centers	Dialysis units, 1981		51	33	16
	Home health agencies	Visits, 1983		64	26	10
	Nursing homes	Establishments, 1985	19,100	20	75	5
Beds, thousands, 1985		1,121.5	23	69	8	
Education	Primary & secondary	Establishments, 1990–1991	109,228	23	?	77
		Enrollment, millions, 1990 ¹	45.4	10	<1	89
	Post-secondary	Establishments, 1991–1992	9,983	28	51	21
		Enrollment millions, 1990	13.0	20	2	78
	Noncollegiate	Establishments, 1992	6,382	18	74	8
Two year colleges	Establishments, 1992	1,444	12	19	69	
Four year colleges	Establishments, 1992	2,157	69	3	28	
	Establishments, 1990 ²	71,259	51	36	13	
Child day care		Enrollment in 1000's, 1990	4,315	54	33	13
		Expenditures, billions, 1990	150.0	17	72	11
Research	R&D	Expenditures, billions, 1990	21.5	69	20	11
	Basic research	Revenue, 1979		65	5	30

Sources: Hospitals: American Hospital Association (1992); HMOs: Gray and Schlesinger, (1994, p. 15); Other health: Schlesinger (1984); Nursing Homes: National Center for Health Statistics (1989) Education: National Center for Education Statistics (1992) and (1993); Child Day Care: Kisker et al. (1991); Research: U.S. National Science Foundation (1990); Art Museums: Kenneth Clarkson, unpublished 1979 paper cited in Steinberg (1987b).

¹The estimate for for-profit schools is Hansmann's (1996) educated guess.

²Both enrollment and establishment data assign Head Start programs 72% to the public sector and 28% to the nonprofit, on the basis of data for 1992–1993 supplied by the Head Start program (Information Report, U.S. Dept. of Health and Human Services). Head Start grantees represented 9% of establishments and 7.4% of enrollees in the underlying source.

in balance, and in a few areas, most notably live theater, nonprofits grew more rapidly.

2. *Altruism and Ideology*

Some people believe that the distribution of income should be more equal and that basic services should be allocated to benefit the disadvantaged. Others believe that particular services, such as health care or higher

education, should be supplied at high levels. Still others would like to propagate particular principles or creeds. These generalized beliefs are distinct from altruistic ties of affection and duty that link family members and close friends.

Altruism toward one's kin has inter-generational survival value in some models. Parents sacrifice for their children, and as a result, the children are more capable of reproduction than

TABLE 5
RATES OF GROWTH OF TAXABLE AND TAX-EXEMPT SECTORS, SELECTED SERVICE INDUSTRIES, 1977-1987

1987 SIC code	Industry	Taxable, establishments, ¹ % change	Taxable, revenues, % change ²	Tax-exempt, establishments, % change	Tax-exempt revenues, % change ³
7922	Theater, etc. ⁴	20	39	77	88
7929	Bands, orchestras, actors, etc. ⁵	15	39	70	58
8051	Skilled nursing care ⁶	65	63	85	63
8052, 8059 ⁷	Nursing and personal care, n.e.c.	-12	-12	65	32
823	Libraries ⁸	-3	165	0	7
824	Vocational schools ⁹	44	82	7	13
832	Individual and family services ¹⁰	128	81	76	92
833	Job training and vocational rehab.	141	112	47	17
835	Child day care ¹¹	89	94	30	35
836	Residential care	85	87	87	65
839	Social services, n.e.c.	-10	-17	33	136
8731 ¹²	R&D labs	97	78	13	66
8734 ¹³	Testing labs	71	75	-9	73

Sources: Calculated from U.S. Department of Commerce, Bureau of the Census (1989) SIC codes were changed between 1977 and 1987 so this table is limited to sectors with little or no change in the sectoral definitions.

¹The percentage changes are overstated since the 1977 Census uses the number of establishments in existence at the end of year count and the 1987 Census counts establishments in operation at any time during the year. For some sectors the end of year count is available for 1987 in Appendix G of the 1987 Census. These numbers are included in footnotes when they are available.

²In real terms using the GNP deflator for the service sector which doubled between 1977 and 1987.

³Expenditures in 1977; receipts in 1987.

⁴The percentage change in the number of taxable establishments was 9% using number of establishments in existence at the end of 1987.

⁵The percentage change in the number of taxable establishment was 7% using the 1987 end of year count.

⁶For the entire SIC 805 sector the percentage change in establishments was 24% and 76% for the taxable and tax exempt sectors respectively using the definitions in this table. Using consistent end of year counts for both dates the percentage increases fall to 17% and 74% respectively.

⁷Combined in SIC 8059 in 1977.

⁸The number of taxable libraries fell by 8% using the 1987 end of year count.

⁹The number of taxable vocational schools rose by 33% using the 1987 end of year count.

¹⁰For SIC 832, 833, 836, and 839 the percentage change was 82% and 62% for taxable and tax exempt establishments respectively using the definitions in this table. Using consistent end of year counts the rates of increase were 67% and 57% respectively.

¹¹The number of day care centers rose by 71% and 25% for the taxable and tax exempt sectors respectively using the 1987 end of year count.

¹²SIC 7391 in 1977.

¹³SIC 7397 in 1987.

other, less fit, children (Theodore C. Bergstrom and Oded Stark 1993). Siblings whose genes or upbringing predispose them to cooperate will, under some conditions, do better than non-cooperators and end up dominating society (Stark 1995). Models based on genetic overlap have only limited rele-

vance, however, to the study of charities. Sociobiology cannot explain gifts of time and money to support genetically unrelated individuals and abstract worthy causes. Nevertheless, related evolutionary models, not based on kinship, demonstrate how altruistic traits, such as heroism, trust, or what Herbert

Simon calls "docility," can have survival value.⁸

Within otherwise conventional models of individual choice, however, others' benefits could affect one's own well-being. Thus paternalists feel better off if the groups they care about consume goods and services of which they approve. Such people might donate to support the education of disadvantaged minority children but refuse appeals to provide general financial support for the poor. In contrast, others, motivated by "liberal affection," benefit from the happiness of others. Such people prefer to make untied monetary grants to worthy people rather than provide in-kind benefits such as housing, food, or family counseling (David Collard 1978, pp. 7–8). Others may have utility functions that depend, not on the happiness or consumption patterns of individuals but on the achievement of some general goal such as a cleaner environment, a high level of artistic creation, or breakthroughs in basic research.

Even if many people have such utility functions, little may be given to charity because of free rider problems. Preferences for a more egalitarian income distribution or higher education levels for the poor could justify government redistributive policy (Harold M. Hochman and James D. Rodgers 1969) and concern for the environment can lead to regulation by the state. Low levels of private giving may indicate, not mean-spiritedness, but free riding. Even those

⁸ Simon defines "docility" as a willingness to be taught or to defer to the superior knowledge of others. Simon claims that successful human societies are ones where docility is psychologically associated with altruism so that the net gain to individuals from docility is positive. Societies able to produce such a psychological connection in its members will be "fitter" than those that are unable to do so. Simon (1992 and 1993, pp. 159–60) speculates about the way such links can be produced through organizational loyalty, religious faith, and nationalism.

dissatisfied with the low level of some publicly provided service (Weisbrod 1977) might not donate to charity.

Individual giving is, in fact, low, at least when compared with government social welfare spending.⁹ Nevertheless, private charity is not unimportant. In contradiction to strong models of free rider behavior, many people donate both time and money to organizations where their own gifts have only an insignificant impact on the level of services provided. Why do they do this if individual gifts have little impact either on beneficiaries or on the achievement of general goals?

One explanation for giving is that donors benefit from the act of giving itself. Although a person who gives money suffers a cost because the money is not available for other purposes, the benefits may be higher than from an equivalent sum donated by someone else. Donors may value not only the benefits supplied by the organization, but also their own acts of charity. For those who benefit from their own gifts, there are three ways of characterizing this psychological phenomenon. First, one might obtain satisfaction only from one's own acts of charity, but not from those of other people. This seems a rather extreme case in which the benefits produced by the charity only matter to you if you caused them. Alternatively, a donor may care about the beneficiaries' overall level of satisfaction, but get an extra kick, or

⁹ In the United States giving was only 1.7% of personal income in 1991 and 1993 (Hodgkinson and Weitzman 1994, table 1.1, p. 16). In Canada and the United Kingdom it was less than 1% (Hodgkinson et al. 1992, table 2.21, p. 81). Excluding giving to religion, United States residents gave 0.57% of personal income in the late 1980s compared with 0.13% in France, and 0.18% in Germany in 1991–1992 (Salamon and Anheier 1994, figure 5.3, p. 65). General government revenue as a percent of GDP was 31.6% in the United States in 1988, 39.6% in Canada, 39.7% in the U.K., 46.5% in France, and 44.6% in Germany in 1989 (OECD 1991, pp. 42–43).

“warm glow,” from his or her own marginal contribution.¹⁰ Third, donors may have a “buying-in” mentality. They may feel that they deserve to feel good about the charitable program only if they have made some marginal contribution to it. For each person, there is a discontinuity in the marginal benefits of gift giving at his or her threshold (Rose-Ackerman 1982). The second and third views can be combined. Donors might face a threshold and once it is past, feel a marginal warm glow from additional gifts. Finally, some charities are so small and some donors are so wealthy that individual gifts do affect service levels in observable ways.

Obviously, the free rider problems associated with charitable actions are mitigated if potential altruists benefit from the act of giving itself, from identification with the recipient, and from the gratitude and affection that recipients lavish on the donors. However, the economics literature has settled on an infelicitous term for this phenomenon. Several articles describe a person as a “pure altruist” who cares only about the benefits flowing to others or about the overall level of some public good.¹¹ Such a donor obtains no warm glow from the act of giving and will tend to free ride in the large numbers case. “Pure altruists” are on such a high, rarified plane that they give nothing. It seems strange indeed to label such people altruists. They look exactly like free riders, except that the

public benefit they consume for free is aid to the needy rather than a public good such as a lighthouse. Why not, instead, characterize these people as having utility functions that depend on the level of some jointly provided benefit, be it a public park, a museum, or aid to the needy? The label of “altruist” would then be reserved for people who feel some moral obligation to help in the provision of charitable services and of jointly consumed goods not provided by the state. In Amartya K. Sen’s (1977) language, such people are motivated by “commitment” rather than “sympathy” for the other. These people, included among the “impure altruists” in some models, are, under this view, the only ones with a legitimate claim to the label “altruist.”

Robert Sugden (1984) has provided one model of “commitment” that is relevant to the nonprofit charitable sector. His view of private donations incorporates not just one’s own attitude toward altruistic activity but also one’s reactions to the altruistic behavior of others. He posits that most people believe that free riding is morally wrong and hence feel an obligation to contribute so long as others do so. He assumes that people believe they should give at least as much as those in their reference group. No one feels an absolute moral imperative to contribute a particular amount, but defines his or her obligation in reference to others.¹² Such a model of donations produces multiple equilibria only one of which is efficient. Every other equilibrium involves undersupply of the public

¹⁰ Kenneth Arrow (1972); Steinberg (1978a). The term was coined by James Andreoni (1989, 1990). Empirical work suggests that among the motives for giving are social desirability, career advancement, expectations of respect and recognition, identification with certain groups, positive attitudes toward the community, as well as altruism. Blood donors express humanitarian or altruistic motives along with feelings of self-satisfaction or pride (Piliavin and Charng 1990, pp. 55–56).

¹¹ This terminology has been employed by Andreoni in 1988, 1989, and 1990. The approach is derived from Gary Becker (1974, pp. 1083–85).

¹² Sugden’s principle of reciprocity is as follows. Let G be any group of which individual i is a member. Suppose that everyone in G except i is making an effort of at least E in the production of some public good. Then let i choose the level of effort that he would most prefer that every member of G should make. If this most preferred level is not less than E , then i is under an obligation to the members of G to make an effort of at least E (Sugden 1984, p. 775).

good. Sugden argues that this model of reciprocity accords with the facts of charitable giving better than competing theories because it predicts some altruistic activity, but at an inefficiently low level.

Some giving is the result of feelings of commitment; some results from sympathy; some arises from belief in the moral value of reciprocity; some is motivated by private benefits to the donor such as prestige, pride, and attendance at elite parties. Motivations for giving are inextricably linked. One can obtain prestige from making a gift only if others view one's action as worthy. If the narrow private benefits of gift giving are too obvious and large, gift givers will not be praised for their self-sacrifice.

Donors' underlying motivations have implications for the funding strategies of nonprofits. If sympathy is the dominant motivation, individualized stories of hardship should be most effective. If commitment dominates, reports on the overall effectiveness of the organization's programs are needed. If gifts are reflections of religious beliefs, the organization should stress its commitment to the donor's faith. Solicitation by friends and neighbors is useful if people want others to view them as good and generous. Empirical work has not succeeded in providing hard evidence on the motivations for charitable giving. Such information as exists, however, confirms Simon's (1993) emphasis on ethnic and religious ties, class and organizational loyalties, and nationalism as generators of altruistic actions. A high proportion of charitable activity in the United States involves religious and educational institutions to which donors have close personal ties (see Table 1). Over half of the those who volunteered to the charitable sector in 1993 donated time to religious organizations (Hodgkinson and Weitzman 1994, table 1.6, p. 23). Youthful experiences of

helping others and present day religious commitment are related to donations of money and time. Individual charities are more likely to obtain a person's help if they use a close friend, a clergyman, or a fellow worker to solicit a donation (Hodgkinson and Weitzman 1994, pp. 61–89).

Experimental work has taken a few steps toward understanding altruistic behavior (see John Ledyard 1995 for a review). This work generally has focused on the voluntary provision of public goods consumed by the experimental subjects, not on aid to the needy. The "public good" is usually a sum of money that is an increasing function of the voluntary contributions of the subjects. Such an experimental design permits a straightforward measure of the difference between individual contributions and the efficient level of provision. The experiments generally are structured as multi-person prisoner's dilemma games where a zero contribution is in everyone's narrow self-interest. According to Ledyard (1995, p. 172), the results contradict "hard-nosed" game theory because some voluntary contribution always occurs. Substantial free riding goes on, however, with the most common result being contributions equal to 40 percent to 50 percent of the optimum. The percentages range from 10 percent to over 80 percent of the optimum. Although the results are fairly robust, the actual details of behavior are very sensitive to the design of the experiment. Repetition generally reduces contributions, and communication between subjects and between subjects and experimenters affects the outcomes. The experimenters generally avoided moral appeals to their subjects, but when such appeals were made, there is some evidence that contributions increased (Ledyard 1995, p. 169). Sugden's claim that individual moral imperatives include

an obligation to match others' gifts also receives some support.¹³

A second type of empirical work finesses the issue of why people give and asks how gift giving is affected on the margin by the opportunity cost of charity. Economists have examined the impact on donations of marginal tax rates and changes in government spending. Increases in marginal tax rates both lower the price of tax deductible gifts and decrease the disposable income of donors. These factors work in opposite directions. People will tend to give more because the tax benefits are greater (that is, the price is lower) and will tend to give less because their income is lower. The first wave of research on this topic generally concluded that giving was price elastic (greater than one in absolute value) and income inelastic (less than one) (Clotfelter 1985). These results imply that charities on the average will lose revenues when marginal tax rates are reduced. More recent research casts doubt on the price elasticity claim. Some studies found that giving was price inelastic (Steinberg 1990). Other work suggests that the wealthy have very price elastic donation functions while others have inelastic demands (Steinberg 1990a, p. 76; R. Hamilton Lankford and James H. Wyckoff 1991). Distinguishing between permanent and transitory changes, William C. Randolph (1994) finds that transitory price elasticities are much higher and income elasticities are much lower than permanent income and price effects. People time their gifts to take account of transitory benefits, treating current and future giving as substitutes.

A more complete characterization of the relationship between the public and the nonprofit sectors should consider the

extent to which government spending crowds out private donations (Rose-Ackerman 1987). Some scholars claim that the crowd-out will be 100 percent under the assumption that people care only about the overall level of public services, not their own contributions. Although some researchers have found empirical support for this theoretical claim (Russell Roberts 1984), most evidence does not appear to confirm it (Steinberg 1993). Charitable contributions are not currently zero, and many people donate who have no measurable impact on the level of services. Nevertheless, most studies find that the elasticity of gift-giving with respect to government spending on substitutes is negative. Depending on the price elasticity of private giving, subsidizing giving may be more efficient than taxation (Roberts 1987). This topic, however, is not as well researched as the impact of marginal tax rates on gifts. Little work exists, for example, on the link between donations and government support of particular nonprofits. One exception, a study of contributions to public radio stations, found that individual gifts fell when government support increased but far less than dollar for dollar (Bruce Robert Kingma 1989; and Kingma and Robert McClelland 1995). Conversely, a study of hospitals in New York State, which receive few donations in any case, found that the already low level of private giving was unaffected by changes in the form and level of public subsidies (Kenneth E. Thorpe and Charles E. Phelps 1991).

3. *The Economic Function of Nonprofit Organizations*

Nonprofit firms operate under a non-distribution constraint. No one has a legal claim to the organization's earnings, but such firms may, in fact, earn surpluses. These funds may be reinvested in

¹³The evidence is indirect. In several experiments those with a propensity to cooperate tend to believe others are more likely to cooperate (Ledyard 1995, pp. 163-64).

the organization, kept as endowment, or used for other charitable purposes. What function can such organizations serve?¹⁴ Three interrelated possibilities seem most important.

First, donors may be willing to donate only to nonprofit institutions. Given the difficulty of monitoring charitable work, donors may fear that for-profit firms will convert gifts into profits for the owners. Although nonprofit managers can, of course, embezzle or misuse funds, at least using a nonprofit for private gain is illegal. Thus if one wishes to make a gift, nonprofits should be able to compete for such gifts better than for-profits (Hansmann 1980). In fact, most private giving is channeled through nonprofits. Although both for-profits and governments do receive some donations of time and money, the vast majority goes to nonprofits, and core government departments are seldom the recipients of private charity.

Second, nonprofits may be a response to information asymmetries faced by customers (James and Rose-Ackerman 1986, pp. 20–23; Steinberg and Bradford H. Gray 1993; Weisbrod 1989). Customers, like donors, may favor nonprofits because they believe that they have less incentive to dissemble because the lack of a profit motive may reduce the benefits of misrepresentation. Thus if poorly informed customers find it costly to determine quality before purchase, or even after purchase, they may prefer a nonprofit to a for-profit provider. They

¹⁴ Because a number of excellent survey articles and edited volumes are available on this topic, I will provide only a brief summary here. A seminal piece is Hansmann (1980). That article along with other important articles on the nonprofit sector are reprinted in Rose-Ackerman (1986). Other valuable overviews are the articles by Hansmann and Steinberg in Walter W. Powell, ed. (1987); Estelle James and Rose-Ackerman (1986); Weisbrod (1988); Ben-Ner and Theresa Van Hoomissen (1993). An international perspective is provided by Anheier and Seibel, eds. (1990).

may select a nonprofit even if they do not agree completely with the nonprofit's underlying philosophy. Services that people purchase for their close relatives provide examples. Nonprofits may have an advantage for some buyers in fields such as nursing home care for the old and day care for the young.

In this context, public firms ought to share the same advantages as nonprofits. Nonprofits will have an edge over public sector providers only if nonprofits can be monitored and controlled more easily by customers. One situation in which this is likely to be so is when the nonprofit is organized as a *de facto* consumer cooperative. Consumers overcome their information deficit by actually running the organization (Ben-Ner 1986).

Third, nonprofits may provide a more diverse collection of services than is possible in the public sector. The voluntary sector may foster experimentation and permit those who represent unpopular or extreme ideologies to put their ideas into practice without imposing them on everyone else. People who are dissatisfied with the low level or quality of some government services and wish to supplement public provision may establish nonprofits (Weisbrod 1977). Both experimentation and freedom may be encouraged by a system that makes it easy to establish a nonprofit.

The third function of the nonprofit sector interacts with the first. General explanations for private donations such as those put forward by Sugden and Sen say nothing about how gifts will be allocated or about what types of organizations will be able to attract gifts. These explanations for altruistic behavior are consistent with gifts to public agencies as well as to private organizations. Here is where the diversity of the nonprofit sector proves important. Some people care about ideas as well as objects and people. Rather than simply wanting to "help

others" or "support culture" in a generalized way, they have particular beliefs about the best way to do these things. They feel pleasure when an idea they support is reified in a service-providing or advocacy organization. Nonprofits are better positioned than either governmental or for-profit firms to serve this reification purpose. Government agencies are usually too constrained by legislative mandates and demands for uniformity, and for-profits must satisfy a market survival test.

These claimed advantages of the nonprofit form have not gone unchallenged. Critics argue that nonprofit managers have little incentive to manage their firms efficiently because no one has a claim to the residual earnings. Of course, the separation of ownership and control in large modern for-profit corporations also gives managers room to act inefficiently. Managerial shirking, however, may be an especially serious problem in nonprofits simply because no market in ownership shares exists to discipline runaway managers. In addition, lacking market discipline, firms may continue in existence when they are performing no valuable function (Hansmann 1996; Seibel 1990). The success of the nonprofit sector is viewed as an artifact of favorable treatment by government. Exempt from the corporate income tax and the property tax, nonprofits can thrive even when they fail to attract many private donations. The tax deduction for private donations may attenuate donors' incentives to monitor the use of their gifts.

Other critics claim that nonprofits that are heavily dependent on government funds are in a different category from privately supported nonprofits. They accept the claimed advantages of the nonprofit form outlined above, but argue that they do not apply to publicly funded organizations. In the social welfare field

many nonprofits receive substantial public support and some organizations were created to take advantage of new public funding opportunities (Steven Rathgeb Smith and Michael Lipsky 1993; Salamon 1987). Hospitals are heavily dependent on Medicare and Medicaid money. The tremendous growth in the nursing home industry, both nonprofit and for-profit, was fueled by the federal Medicaid program. Twenty-eight percent of Head Start programs are nonprofit organizations with almost 100 percent public funding (U.S. Department of Health and Human Services 1994). In the subsidized housing sector community-based nonprofits entirely funded by government are playing an increasingly important role (Michael H. Schill 1994). Some argue that, at least in the health care sector, the growth of public subsidy has eliminated the justification for providing tax exemption to nonprofits (Robert Clark 1980). In contrast, Seibel (1990) claims that in a modern welfare state government supported nonprofits can fill a specialized organizational niche. The very inefficiency and unresponsiveness of some nonprofits helps alleviate contradictory societal and political demands faced by modern governments. Nonprofits survive *because of*, not in spite of, their inefficiency.

Another group of critics condemns, not the special advantages provided to nonprofits, but their acceptance of public money. Supporters of volunteerism and community action are frequently critical of the regulatory intrusions that accompany public programs, arguing that they undermine one of the main advantages of the nonprofit form. Others note that the government, in contracting with private agencies, must uphold public values and needs to assure financial accountability for taxpayers' dollars. However one evaluates these developments, they suggest that nonprofits' role as ad-

vocates for unpopular causes and disenfranchised groups may be inconsistent with the receipt of public money. A bifurcation may be developing in the nonprofit sector—with some organizations carrying out service programs using public money and others focusing on advocacy (Steven Rathgeb Smith and Michael Lipsky 1993).

4. *Competition Between Nonprofits and For-Profits*

For-profit firms are active in most service sectors where nonprofits operate, but they do not necessarily dominate nonprofits (Tables 3, 4, and 5). Although for-profit firms are, on average, larger than nonprofit firms in the economy as a whole, this is not true in the industries where they coexist. There, nonprofit firms are generally larger on average.¹⁵ Many are old and well-established and have substantial endowments. Some are part of stable, long-running national franchises (Sharon Oster forthcoming). New nonprofits are being established in industries such as day-care centers and nursing homes where for-profit entry is also occurring (see Table 5 above). How can we explain the persistence of mixed service sectors where nonprofits, for-profits, and public providers exist? Why doesn't one form drive out the others?

¹⁵According to the Census of Manufacturing the average number of employees per firm in the manufacturing sector was 51 in 1987. The nonprofits included in the 1987 Census of Service Industries averaged 38 employees. Table 3 above shows that in most subsectors nonprofits accounted for a larger share of revenues than of establishments. According to the 1987 U.S. Census of Service Industries, tax exempt firms also have more employees than taxable ones in most sectors. The difference is especially large for hospitals where tax exempt hospitals (both governmental and private nonprofit) average 672 employees compared with 263 for taxable hospitals. The average number of employees for nursing and personal care facilities (SIC 805) is 72 for taxable firms and 90 for tax exempt. For child day care the numbers are seven and eleven respectively.

Skeptics argue that the continuing viability of the private nonprofit sector is simply an artifact of its favorable status under tax and other laws that favor nonprofits by making for-profits ineligible to participate in public subsidy programs. They also point to private accreditation organizations that impose extra requirements on for-profits or use criteria that would exclude most for-profits.¹⁶ Other critics suggest that barriers to exit imply that the nonprofit sector is larger than is economically efficient. Some observers have speculated that age, size, and level of capitalization will be positively associated with a nonprofit's survival probability. The sketchy empirical evidence available confirms the hypotheses concerning nonprofits' survival probabilities (Bowen et al. 1994, pp. 100–04; Per Selle and Bjarne Øymyr 1992). These findings, however, are not strong evidence for the proposition that nonprofits are more reluctant to exit than for-profits because one would expect a similar pattern of exit probabilities to exist for for-profits.

¹⁶*Marjorie Webster Junior College, Inc., v. Middle States Association of Colleges and Secondary Schools, Inc.*, 432 F.2d 650 (U.S. App. D.C., 1970), upheld an accrediting organization's refusal to accredit a proprietary junior college on the basis of a policy statement of the Federation of Regional Accrediting Commissions of Higher Education and its own past practice. The court, however, left open the possibility that it might intervene in future cases unless standards were "reasonable, applied with an even hand, and not in conflict with the public policy of the jurisdiction."

The accrediting requirements of the National Association of Schools of Art and Design (1993, pp. 108–09), the National Association of Schools of Dance (1994, pp. 67–68), and the National Association of Schools of Music (1993, pp. 141–42) all contain practically identical language limiting the money making possibilities of for-profit schools. Both the Middle States Association of Colleges and Schools (MSACS 1994) and the North Central Association of Colleges and Schools (NCACS 1992) have standards that severely limit the profit making possibilities of accredited educational institutions, but only the NCACS explicitly requires disclosure of legal form.

The preceding section listed some benefits and costs of the nonprofit form. The important remaining question is why anyone would found a nonprofit in an industry where for-profits can break even. Even when the heterogeneous tastes of customers create a niche for nonprofit provision, we still need to explain how nonprofit entrepreneurs can overcome the inefficient incentives created by the lack of owners. To begin, consider the possibility that ideological commitment plays an important role. Two issues must be considered. First, is it plausible to suppose that ideologues would prefer the nonprofit form of organization? Second, are there advantages to customers or government agencies of selecting a service provider riding an ideological hobbyhorse?

If the answer to these two questions is yes, then when customers are observed to patronize nonprofits, they may be selecting the services of committed ideologues. Organizational form, *per se*, may not serve an important signaling function for patrons. It may only be an indication that certain kinds of entrepreneurs and managers find the nonprofit form desirable.

An ideologue is a person with strong beliefs about the proper way to provide a particular service. He or she espouses an educational philosophy, holds religious beliefs that imply certain forms of service delivery, or subscribes to a particular aesthetic or psychological theory. Why might such people concentrate in the nonprofit sector? The main advantage of the nonprofit form to the ideologue is the absence of owner-investors. Of course, a for-profit business wholly owned by the principal could also eliminate outside investors, but if the firm's founder is motivated by ideas rather than profit, relatively modest tax or regulatory benefits would push the founder in the nonprofit direction (Rose-Ackerman

1987; Preston 1992). The legal constraints imposed on the nonprofit firm's mission may be an advantage to those who hope that their ideas and projects will outlive them. Therefore, within any given individual service sector I would expect that nonprofit providers would include more ideologues than the competing for-profit firms.

It is clear that much nonprofit entrepreneurship is ideological in character (James 1987a, 1989; Dennis Young 1983). James (1986, 1987b, 1993) has carried out the most systematic empirical work focusing on primary and secondary education. She finds that religious and linguistic differences are important in explaining the share of nonprofit schools both internationally and within countries. She interprets her results as demonstrating, not only demand for religiously and ethnically specialized schools, but also the willingness of committed individuals and organized religious groups to found such schools.

But why should paying customers patronize firms run by ideologues who produce services that satisfy their own idiosyncratic beliefs or express their religious faith? Why not purchase from a for-profit firm motivated to satisfy consumer tastes? An organization with committed founders and managers has two possible benefits: the "quality control" advantage and the "product differentiation" advantage. Ideological founders will seek to hire managers and employees who share their vision. Because these employees want the services they provide to reflect these values, they will need little monitoring. Committed employees may be easier to attract if the firm is a nonprofit. The lack of equity holders is a signal to employees that their selflessness is not enriching someone else. High level professional employees may accept lower levels of pay in return for greater certainty that their

efforts are actually helping to achieve their altruistic goals. Empirical support for this claim is provided by Preston (1989), by Weisbrod (1983) for lawyers, and by Myron J. Roomkin and Weisbrod (1994) for top executives in hospitals.¹⁷

Similarly, the organization's goals may attract private donations that supplement the payments of private customers or government agencies (Marc Bilodeau and Al Slivinski 1993). For these reasons a nonprofit may have a quality advantage over a for-profit and may in some cases have a cost advantage as well.

Some service sectors include another margin of choice. Providers may choose their customers from a range of "applicants." If the quality of service is partly a function of who else consumes it, even for-profit providers may screen potential customers. Ideologues may, however, have an additional reason for screening. Their own beliefs may be better realized if they can select "desirable" applicants. Thus a teaching hospital might concentrate on difficult, interesting cases; a university might screen for high intelligence and strong high school records, and an old age home might favor people with the same religious beliefs as its founders. This strategy will, of course, work only if the nonprofit provides a price-quality mixture demanded by a sufficient number of customers to produce excess demand. Nonprofit screening will be most successful when the selection criteria produce a service environment that many customers value. For example, a university that has a highly intelligent, well-educated student body is likely to be one that many young people want to attend. The nonprofit does not raise

prices or lower quality in response to excess demand for its services. As a result, however, many people may not be served by the nonprofit sector. "Cream skimming" by ideological nonprofits leaves a niche for for-profit or government providers to fill with lower quality services that are not necessarily lower priced (Rose-Ackerman 1986).

Ideological firms may not, however, produce a customer's preferred variety of service. The firm's cost advantage might be outweighed by the unattractive types of service it provides (Seibel 1990). A nonprofit hospital, for example, might provide care to the indigent, a service of value to the board of directors but of little interest to consumers. To satisfy such altruistic goals and still attract customers, the hospital must attract donations or grants, be more efficient than its competitors, or operate in an oligopolistic market where all firms earn excess profits. One study has shown that the stronger competitive pressures are within a market area, the less uncompensated care is provided by all types of hospitals. Nonprofits provide more charity care than for-profits, but provide less in more competitive markets (Mark Schlesinger et al. 1987, pp. 39-40).

Ideologues are not, however, necessarily at a disadvantage in satisfying consumers. Instead, ideologues might have a second, product differentiation advantage. In some service sectors, arts and culture, for example, customers may have relatively poorly formed tastes and may rely on producers to come up with new ideas. Because the quality of a performance can not be evaluated confidently until after one has attended it, some consumers may prefer to rely on ideologues with strong views. The credibility of an entrepreneur's claim to be providing "quality" art, may be enhanced by firm's claim to have rejected profit as a goal. Similarly, educational and psycho-

¹⁷ John H. Goddeeris (1988), however, argues that Weisbrod's (1983) study of lawyers overstates the differences in earnings because of selection bias. Roomkin and Weisbrod (1994) found a pay difference only for top hospital executives. Middle managers experienced no pay differences.

logical research is divided on the most effective way to educate children and treat mental illness. Multiple theories abound. Poorly informed customers or their relatives may want to rely on experts or specialists. However, they may fear exploitation. They seek providers with a clear service philosophy, but patrons differ on what set of principles they want embodied in schools and psychological care. The commitment of the provider to Dewey, Montessori, Freud, or the Roman Catholic Church acts as a signaling device. Customers are buying reified ideology.

Of course, for-profit arts organizations, schools, and psychiatric hospitals could also announce their commitment to particular philosophies. An overtly mercenary attitude may not be profit maximizing. The firms that earn the most profits may be the ones that convince customers that they have artistic or humanitarian motives. However, when customer information is poor, firms may be unable to convince customers that their intentions are not mercenary unless they actually renounce private profits by organizing as a nonprofit. In contrast, if customers can observe the attitudes and behavior of personnel, for-profits can compete on equal terms. Investors' interests are aligned with those of customers. But this community of interest may be fragile. The for-profit may face a daily struggle between short-term opportunism and long-term customer satisfaction. In that case, the combination of ideology and nonprofit organizational form may act as a guarantee that neither could provide on its own.

Nevertheless, although entrepreneurs may choose the nonprofit form to make their altruistic motives credible, the sector's "aura" may be misleading. The nonprofit form can sometimes mask private profit-seeking activities. Burton Weisbrod (1988) calls such firms "for-profits

in disguise." The risk of such opportunistic behavior will be more important the greater the public subsidy provided to nonprofits, and the more regulatory constraints favor nonprofits. If the financial benefits of the nonprofit form are very large, the monitoring task of the government is increased. The higher the level of monitoring, the greater the risk that state oversight will undermine the product differentiation and quality control benefits of the nonprofit sector. For example, one might argue that because nonprofits appear to provide higher quality nursing home services than for-profits, this implies that Medicaid money should be spent only on nonprofits. Such a policy would, however, be risky for the government. Given the financial importance of Medicaid patients to the industry, such a rule would encourage profit-seeking providers to organize as nonprofits and hide their profits through real estate deals and other dodges. The very effort to favor nonprofits can undermine the reputed benefits of using the nonprofit form of organization.

5. Empirical Evidence

Given the conflicting claims about the value of nonprofit organizations, empirical research is essential. One would like to know if nonprofits actually do provide higher quality and more varied services and if potential customers use the nonprofit form as a signal of high quality. Are nonprofits more or less efficient than comparable for-profits, and do they, in fact, have difficulty raising capital? What role do tax and regulatory laws play in the competition between nonprofits and for-profits? Do government grants and contracts undermine the quality control benefits of the nonprofit form relative to either public or for-profit production?

Empirical work on the importance of

organizational form is at an early stage. The first studies analyzed industries where nonprofits and for-profits were providing the *same* services, such as health insurance, and compared the efficiency of firms. This work, rooted in the idea that the profit motive is an important spur to efficient operation, generally found that nonprofits were less efficient than for-profits (Kenneth Clarkson and Donald Martin, eds. 1980). Although this research demonstrated that neither private customers nor the government should automatically favor nonprofits, it missed an important point: Nonprofits do not necessarily supply the same services as for-profits. Nonprofits can arise to fill a market niche when information asymmetry and trust are important. Successful nonprofits should generally provide *different kinds* of goods and services or appeal to *different types* of customers than for-profits. In such cases the concept of relative productive efficiency is not well defined. Although productive efficiency *is* important, by focusing only on such measures, the early work assumed away the major arguments for survival of the sector even in a world with no tax benefits.

Recent work has examined industries where the lack of a profit motive can serve a positive function. Several studies have considered the nursing home industry where nonprofit, for-profit, and government providers coexist. The results are roughly consistent with the theory (Catherine Hawes and Charles D. Phillips 1986; Weisbrod 1988, 1994; William E. Aaronson, Jacqueline S. Zinn, and Michael D. Rosko 1994). One study of nursing homes recorded more complaints against proprietary than against nonprofit homes (Weisbrod and Schlesinger 1986). Another study concluded that poorly informed people were more likely to select nonprofit nursing homes (Alphonse G. Holtman and Steven G.

Ullman 1993). Weisbrod (1988, pp. 155–58) found that nonprofits providing long-term care generally take less advantage of their informational superiority over customers than do for-profits. Religious nonprofits differ more from for-profits than do secular nonprofit providers. More recent work by Weisbrod (1994) confirms these results for both nursing homes and facilities for the mentally handicapped.

Studies of child day care produced similar results. Although there is a good deal of within sector variation, nonprofits rank higher along various input measures such as child/staff ratios and the training of teachers. On the average, for-profits are providing satisfactory, but somewhat lower quality, service (Sharon L. Kagan 1990; Kisker et al. 1991).

Other work suggests that higher quality comes at a cost. Nonprofit nursing homes apparently have costs five to 15 percent higher than for-profits (Theodore R. Marmor, Schlesinger, and Richard W. Smithey 1986; G. Arling, R. H. Nordquist, and J. A. Capitman 1987). A study of day care showed that, although for-profits have no cost efficiency advantage over nonprofits, for-profit firms generally provide lower quality and less expensive services (Anne Preston 1993).¹⁸

Thus when nonprofits provide higher quality services, they may also charge higher prices to compensate, reducing their advantage. When nonprofits and for-profits compete directly on quality and price, each may inhabit a different market niche. When the nonprofit form provides no special advantage, however,

¹⁸The independent nonprofits in Kisker et al. (1991) did charge higher prices on average than for-profits but the difference was only about 25 cents an hour and was probably mostly accounted for by differences in costs based on lower child/staff ratios and higher wages. See also Weisbrod (1988, p. 156).

prices and quality can be expected to converge (Howard Tuckman and Cyril Chang 1988). Nonprofits, however, do not appear to be completely exploiting their market power. Private "selective" colleges and universities do not raise tuition to choke off excess demand and even provide financial aid (Bowen and David W. Breneman 1993). Similarly, nonprofit nursing homes and other long term care facilities, especially those with religious affiliations, are more likely to have waiting lists than for-profits (Weisbrod 1994).

Research on hospitals contrasts with studies of day-care centers, nursing homes, and other long term care facilities. Recent studies demonstrate that a hospital's organizational form is not associated with differences in quality or cost once differences in patient mix are taken into account. Physicians make the basic decisions about hospital services, and they appear unaffected by the organizational setting in which they are operating (Marmor, Schlesinger, and Smithey 1986, pp. 334-35; Richard G. Frank and David S. Salkever 1994, pp. 131-32). Although the differences are apparently narrowing, nonprofits do, however, provide more uncompensated care than for-profit hospitals (Marmor, Schlesinger, and Smithey 1986, pp. 336-39; Schlesinger et al. 1987). These results suggest that professional norms can, under some conditions, provide quality control benefits for customers. Hospitals may be unique, however, in the high degree of professional control over output.

6. *Conclusions and Recommendations*

The nonprofit sector is not just a receptacle for charitable donations. Although private charitable impulses are important determinants of nonprofit activity, they are not a sufficient explanation for the size and growth of the sec-

tor. Nonprofits also provide government subsidized services and sell their output to the public. They are concentrated in the service sector of the economy. Yet many industries well-populated by nonprofits also contain large numbers of for-profit firms and government suppliers. The presence of these mixed sectors leads one to ask if there is anything distinctive about the nonprofit form. What are the links between human motivation and organizational structure? Does organizational form determine behavior, or does it provide a flexible structure that can accommodate a wide range of human objectives? Clearly, the nonprofit form is not in itself a guarantee of high quality, altruistic performance, but neither is it a signal of a slack and inefficient organization. Because no one has a legal claim to the nonprofit firm's earnings, potential entrepreneurs and funding sources will select the sector only if they have goals other than single-minded profit maximization. Only if the tax and regulatory benefits of the nonprofit form become too large, will charlatans select it as a way to get rich.

But it is not sufficient to argue that nonprofits are not a threat to the viability of the market economy. Do they also serve affirmative purposes? They can perform three interrelated roles that will be more or less important depending upon the role of government, upon the characteristics of the population, and upon the nature of services provided. These roles are based on trust, generosity, and ideology. First, an organization that binds itself not to distribute its surpluses to owners may be trusted more by customers and donors unable to judge service quality directly. Nonprofits may have a competitive advantage if customers have imperfect information about service quality.

Second, nonprofits can be outlets for the generous impulses of individuals.

The nonprofit form provides a weak guarantee to donors that their funds are not being syphoned off as profits. Public agencies may sometimes serve this role as well, but independent nonprofits, less constrained by majoritarian claims, can better reflect the desires of donors.

Third, nonprofits provide a shell within which people can reify their ideological beliefs without having to be accountable to profit-seeking investors. Ideological entrepreneurs, not focused on amassing wealth, will disproportionately select the nonprofit form. Clearly, this third function is related to the first two. A nonprofit organization can survive only if it can attract money and customers, and in some cases its ideological character will facilitate both of these tasks. Both experimentation and sheer oddity can be accommodated so long as the entrepreneur is independently wealthy, can attract donations, or can break even serving the public.

The benefits of the nonprofit form depend on the relative efficacy of alternative control mechanisms and on the benefits to consumers of purchasing from ideologues. Short of policies that simply improve the information available to consumers, two substitutes for organizational form are important. The first is government regulation with or without public subsidy, and the second is professional training. Either or both can place for-profits on the same competitive plane with nonprofits in markets where customer information is imperfect.

Public regulation may solve the customers' information deficit but may come at the cost of imposing uniformity on the range of services offered. Often such uniformity is undesirable. For example, in early childhood education and care the link between inputs and outputs is poorly understood. In the arts and in religion, tastes and beliefs vary widely. In both cases service variety is desirable

and provides benefits for society at large. In such service sectors, regulation should not impose uniform quality standards but should focus on health and safety issues and on preventing obvious abuses. Heavy-handed regulation will undermine the benefits of ideological diversity and service differentiation. A lightly regulated nonprofit sector may provide higher levels of both diversity and quality than a regulatory regime that eliminates the differences between organizational forms.

The regulations that accompany direct public subsidy may also erase the distinction between firms with different organizational forms. If the government promulgates uniform accountability standards for all participating firms, and if most controls apply to the entire institution, not just to subsidized clients, then public money becomes the primary determinant of performance. Organizational form may become irrelevant. Nonprofit status would matter only if the government itself makes distinctions in implementing its programs. Thus when public money is dominant and when public regulation is pervasive, nonprofits have little claim to special treatment. Although they should remain a legal organizational option and be able to accept tax deductible gifts, other benefits such as regulatory exemptions or special eligibility for subsidies lack a strong justification.

The tax deductibility of gifts should be subject to scrutiny. This benefit is tied in only a loose way to nonprofit organizations' programs. The IRS evaluates the charitable purpose of the nonprofit, not its conformity with some standard of efficacy or quality. The subsidy encourages spending that has social benefits beyond those of the donor while avoiding public judgments about the value of alternative ideologies. One could, however, imagine more egalitarian methods of

subsidizing private giving through, for example, a tax credit or even a voucher plan that permitted each person to earmark a certain sum of public money for private charitable activities.

Other government policies that provide special advantages to nonprofits should be viewed with skepticism. The treatment of nonprofits should not be so favorable as to open a large wedge between the sectors. In spite of the possibility of short-term gains, nonprofits run on genuinely charitable principles should oppose subsidy programs that threaten to dilute the value of the signal sent by the nonprofit form.

The benefits of encouraging the development of a healthy nonprofit sector cannot be determined in the abstract. As time passes and policies change, nonprofits may serve more or less important roles in different service industries. Recent commentary has questioned the special role of nonprofit hospitals and long term care providers given the growth of public support and regulation under Medicare and Medicaid. At the opposite extreme there is little doubt that nonprofits will continue their dominance in religion. The government role will remain small in light of the constitutional guarantees of religious freedom and free speech. Future debate over the proper mix of nonprofits, for-profits, and government provision is likely to be most heated in social services, child day care, and education. The debate concerns both the role for the state in direct provision versus financing, and the relative status of for-profits versus nonprofits as suppliers of services. Developments in these industries over the next few decades should help us to understand better the relative strengths and weaknesses of the nonprofit form of organization and to move toward a resolution of some of the vexed empirical issues raised in this survey.

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