The role of the nonprofit sector

When public officials make cuts in programs to help the needy, they generally expect the nonprofit sector and volunteer labor partly to offset them. President Reagan made such an appeal when he came into office, and the latest work-welfare demonstrations draw on nonprofit organizations to supply the jobs welfare participants are expected to perform in return for their welfare benefits. But can nonprofits fill the gap? Crucial though the nonprofit sector appears to be in providing aid to the poor, the aged, the disabled, the sick, and others in society with special needs, little is known about its workings and how it fits in with the two other parts of the economy: government and the private—or proprietary—sector. A new book by Institute affiliate Burton A. Weisbrod, *The Nonprofit Economy* (Cambridge, Mass.: Harvard University Press, 1988), makes it possible to assess how this part of the economy works, what it accomplishes, and what its appropriate role should be. The material that follows is taken from Weisbrod's book.

Nonprofits defined

Contrary to their name, nonprofit organizations can be and often are highly profitable. They are restricted not in how much income they can generate, but rather in how it is distributed. Profit cannot be paid out to owners or anyone else associated with the organization: it must be devoted to the tax-exempt purpose of the organization. It is the profit motive, therefore, not the profit itself, that is restricted, if not eliminated. And in "exchange" for this restriction, the organization is exempted from the corporate income tax and receives a number of subsidies and advantages.

The tax law defines nonprofits as "organizations for charitable or mutual benefit purposes." Weisbrod distinguishes three types: private, collective, and trust. Those in the first group, private or mutual benefit organizations, are self-serving. Though they do not reap a profit for themselves, they may be instruments for generating profits for their constituents: private firms or members. Among them are trade associations, country clubs, labor unions, farmer cooperatives, and chambers of commerce.

So-called collective nonprofits provide benefits to individuals and groups outside of the organization. They operate in the public interest, whether the focus of their activities is medical research, museums, wildlife sanctuaries, environmental protection, or aid to the homeless. Many of the services provided by this group overlap with the activities of government agencies.

"Trust" organizations, the third group of nonprofits, provide goods and services in competition with the private sector, but by eliminating the profit motive they become more trustworthy. The items they produce are those whose quality it is difficult for a consumer to judge. Blood banks, nursing homes, day care centers, and hospitals belong in this category.

In addition to their exemption from the corporate income tax, collective and trust nonprofits receive further special treatment. Contributions to them may be deductible from personal income for tax purposes (among taxpayers who itemize their deductions). They may be entitled to reduced postal rates.[1] They often need not pay their employees the minimum wage or provide coverage for social security and unemployment compensation. Patent laws, copyright laws, and bankruptcy laws favor them. In many states they receive subsidized interest rates on borrowing (tax-exempt industrial development bonds are often issued for nonprofit hospitals and educational facilities). They often pay reduced sales taxes on their purchases and are excused from property taxes.[2]

The collective and trust nonprofits face certain constraints. The proportion of their resources they can spend on lobbying is limited. Organizations that engage in activities unrelated to their principal tax-exempt purposes cannot offer tax deductibility to donors who contribute money for these

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by

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ancillary purposes. Collective and trust nonprofits cannot commit acts that are illegal (they cannot engage in civil disobedience) or are contrary to public policy.

In practice, the distinctions between types of nonprofit organizations and what they can legally do is not easy to make, and a great number of permutations exist. Nonprofits exist alone and in combination with both for-profit and government agencies. A for-profit organization may establish a nonprofit subsidiary; a nonprofit may establish a for-profit subsidiary. They may operate a joint venture. Such combinations are capable of enhancing the profit of the proprietary partner in a number of ways. They therefore require careful watching. Although they generate virtually no tax revenue, nonprofits are a major expense for the IRS staff, which handles more than 50,000 annual applications for tax-exempt status, deals with the complex Constitutional issues that are often raised, such as whether a tax-deductible school can discriminate against blacks, and determines what activities of nonprofits are taxable as unrelated business income. Nonprofits add to the complexity of an already highly complex mixed society. Why then have them?

The need for nonprofits

The need for nonprofit organizations Weisbrod sees as growing out of the limitations of the other two sectors. The main strength of private enterprise is thought to be its efficiency in meeting consumer demands at minimum cost, but it does not respond to any wants or needs that are not accompanied by a money demand. This means that consumers unable to pay will not have their demands satisfied through the private market. And those who are poorly informed—who cannot detect differences in the quality of services, for example—will not find the private market supplying higher quality when lower quality can be sold at the same price.

To some extent the public sector—government—can correct the failures of the private market. Government can finance, mandate, or otherwise encourage the provision of goods and services that are unprofitable to the private sector. By taxing it can discourage, and by legislation prohibit, the private sector from carrying out activities that, though profitable to the few, are detrimental to the many—pollution, false advertising, violations of trust.

The government, however, faces limitations in monitoring private industry. Although it is easy enough to crack down on an advertiser who guarantees his product will grow hair in a week, it is much more difficult to measure whether a nursing home provides the solicitous care that relatives of helpless patients hope they are purchasing. And the more difficult it is to gauge whether an organization is supplying what consumers want, the more expensive and unsatisfactory monitoring becomes. It is easier, then, for government simply to control what the company does with its profits, on the assumption that without a profit motive, there will be little or no incentive to cut corners at the expense of poorly informed consumers.

Government has a second drawback. Because it relies on the political process, it responds to the needs of the majority. Although the majority may see the need for national defense, public health, medical research, and zoos, they may not see the need for as much of these collective goods as some people would like to supply. Nonprofit organizations are the means by which citizens who want more of some collective good or service—whether concert halls or shelters for the homeless—can supply that need.

Nonprofits, then, are outlets for altruism and furnish trustworthy alternatives to profit-oriented provision of services and goods that are difficult to measure. Do they work? Their detractors complain that they differ from private operations only in that they are less efficient. A few empirical studies by Weisbrod and others, however, suggest that this is not the case. A study comparing nonprofit and proprietary nursing homes, facilities for the handicapped, and psychiatric institutions, for example, revealed that families of patients are more likely to be satisfied with the care their relatives receive in nonprofit institutions over the long term; proprietary nursing homes use more sedatives to control their patients than do nonprofits; and nonprofits use waiting lists rather than higher prices to ration access.[3] Administrators of nonprofit organizations also tend to have different goals from administrators of proprietary firms.[4]

The size of the nonprofit sector

Making use of the limited data available, Weisbrod estimates that there are nearly one million nonprofit organizations in the United States. About 40 percent of the total offer tax-deductibility (they are in the collective or trust category), and this group is growing at the fastest rate. The number of nonprofits nearly tripled between 1967 and 1984, and the revenues of nonprofits grew from $115 billion in 1975 to $314 billion in 1983.

Individual nonprofits tend to be small, and nonprofits altogether own only 1.8 percent of the nation's assets. Compared to the private sector, this is a small amount, but it is 50 percent of the assets of the federal government and 15 percent of the assets owned by all levels of government in the country.

Because nonprofits are typically labor-intensive, they are far more important as employers of labor than as contributors to national output. According to Weisbrod's estimates, the nonprofit sector accounts for employment of from 7.9 million to 10.3 million workers. In 1976 this equaled 12 percent of the nation's full-time labor force of 74.4 million. Many of these employees are concentrated in the health services and education.

In addition to paid workers, unpaid volunteers supply billions of hours of time annually. It is estimated that in 1985 there were 6.7 million (full-time equivalent) volunteers in the labor force. Of these, 5.3 million were working in the nonprofit sector.

Financing nonprofits

The government gets its revenues from taxes, and private enterprise exists by selling goods and services and by selling shares in the capital market. Where do nonprofits get their funds? The answer depends on the individual organization. Mutual-interest nonprofits generally charge dues and sell goods and services to their constituents. Those who provide trust and collective goods and services may also charge dues and make sales, but they depend heavily on contributions, gifts, and grants. They are financed to some extent by all taxpayers when individual taxpayers make tax-deductible contributions. Government also contributes directly, especially to health service organizations.

A growing number of nonprofits operate businesses. They compete with for-profit firms, the government, or both. Nursery schools operated by local churches and other nonprofit agencies compete with profit-oriented schools. Nonprofit hospitals compete with for-profit investor-owned hospital chains. Museums sell reproductions, jewelry, and gifts. College bookstores sell course materials. The Girl Scouts sell cookies.

From the point of view of competing private businesses, these incursions of the nonprofit sector into sales are unfair competition. Private research firms claim that they support through their taxes universities that can undercut them. Travel bureaus operated by universities, sales of hearing aids and artificial limbs by hospitals, and many other attempts by nonprofits to enter the marketplace have come under attack. Resentment of the proprietaries who bid against nonprofits for government contracts was so great that in 1983 the regulations were changed so that the costs of taxes were added to the low bid of any tax-exempt firm to give those required to pay taxes an equal chance.

Volunteer labor is another enormous source of revenue for nonprofits. The number of full-time-equivalent volunteers has grown faster than the number of paid employees in the sector and is now equal to 70 percent of the paid employees. The value of donated time is estimated to be 50 percent greater than the total contributions to all nonprofit organizations from all sources in 1980.

Nonprofits and public policy

Weisbrod's principal purpose in describing what is known about the nonprofit sector is to show the complexity and interdependencies of all sectors of the economy. Decisions seemingly unrelated to nonprofits have unintended and therefore unanticipated effects on them, and further repercussions on the entire economy. When the tax code is simplified, for example, and the number of persons itemizing deductions is reduced, contributions to nonprofits go down. Lowering the maximum marginal tax rate also reduces contributions, since the higher one's marginal rate, the greater a bargain a contribution is. Cutbacks in grants from the federal government to nonprofits in the early 1980s has led to the expansion of nonprofits into new activities that have increased competition with the proprietary sector. Volunteer labor is affected by the availability of paid jobs, median income, government activities, and many other factors.

Having examined what nonprofits should do and the extent to which these goals are accomplished, Weisbrod offers proposals to insulate them from pressures to deviate from the social role they are expected to play and to help move the economy to a better balance of responsibilities among private enterprise, government, and the nonprofit sector.

His recommendations include the following:

- Nonprofits should be encouraged in activities that have a significant collective-good character.
- Greater restrictions should be placed on their "unrelated business activities."
- Tax deductibility should be replaced with tax credits for contributions to approved nonprofits.
- Special postal subsidies for nonprofits should be replaced by broader, less restrictive subsidies that encourage fund-raising activities without distorting the means of carrying them out.
- The IRS should be replaced as the principal regulator of the nonprofit sector. The considerable size of the nonprofit economy, its heterogeneity, growth, and expansion into competition with both government and private enterprise require the establishment of a new agency of government to regulate it.
- A comprehensive statistical program should be developed to provide data about the nonprofit sector. ■

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[1]Fund-raising by means of third-class subsidized mail for nonprofits generated 11 billion mail solicitations in 1985.

[2]This last exemption is frequently the source of hostility between large nonprofit institutions, such as universities, and the communities in which they are located. Local governments are obligated to provide police, fire protection, and other services to these organizations and receive no taxes in return.

[3]Weisbrod, *The Nonprofit Economy,* pp. 144–159 and Appendix F. The analysis of the use of sedatives was based on results of a study by Bonnie Svarstad and Chester A. Bond, "The Use of Hypnotics in Proprietary and Church-Related Nursing Homes," School of Pharmacy, University of Wisconsin–Madison, October 1984.

[4]See, for example, James R. Rawls, Robert A. Ullrich, and Oscar T. Nelson, Jr., "A Comparison of Managers Entering or Reentering the Profit and Nonprofit Sectors," *Academy of Management Journal,* 18 (September 1975), 616–623; and Weisbrod, Joel F. Handler, and Neil K. Komesar, *Public Interest Law* (Berkeley: University of California Press, 1978).