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An introduction to the governance and taxation of not-for-profit organizations ☆

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Abstract

This paper provides a brief overview of the current state of the not-for-profit sector and discusses specific governance issues in not-for-profit organizations. We offer an in-depth analysis of the issues that arise when not-for-profit organizations compete against for-profit firms in the same markets. We argue that while competition by for-profit firms can discipline not-for-profit firms and mitigate their governance problems, the effects of this competition are distorted by the not-for-profits' corporate income tax exemptions. Based on a simple general equilibrium analysis, we argue that there is little justification for such exemptions.

JEL classification: G3; G18; H2

Keywords: Not-for-profit; Governance; Taxation

1. Introduction

As the not-for-profit sector continues to grow in the U.S. economy, a better understanding of the sector's efficiency and its governance is essential to many stakeholders, including investor-donors, regulators, and tax authorities. Not-for-profit organizations (NFPs) are especially important in a number of service sectors of

☆The views expressed are those of the authors and do not necessarily reflect the position of the Federal Reserve Bank of New York or the Federal Reserve System.

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the economy—in particular, health care, education, the arts, social services, and political advocacy. Many NFPs sell services or goods that are also provided by for-profit enterprises, such as health care. NFPs and for-profit enterprises are thus often in implicit or explicit competition in some sectors. Although NFPs have weaker governance mechanisms than for-profit firms (e.g. Glaeser, 2003), competition with for-profit firms in the product and capital markets serves as a disciplining mechanism (Hart, 1983).

In this paper, we argue that in sectors in which NFPs and for-profit firms compete, the corporate income tax exemption enjoyed by NFPs can weaken the disciplining effect of for-profit firms' competition, result in misallocation of resources, and invite tax-evasion activities. As many other commentators have noted, wealthy entrepreneurs can avoid paying corporate income tax as well as personal income and estate taxes if they are able to masquerade their firm as a NFP.[1]

In light of these potential distortions and rent-seeking activities, the differential tax treatment of the two types of organizations raises important questions about whether NFPs should continue to receive their favored tax treatment. Although this issue has been examined by economists and legal scholars in the past (most notably in Hansmann, 1981), the tax exemption is generally taken for granted by most commentators, even though there appears to be no strong economic rationale for its existence. Given the strong growth of NFPs relative to the rest of the economy, it seems more important than ever to revisit the wisdom of this policy.

Concerns about the distortionary effects of the tax exemption and a long list of scandals at both philanthropies and not-for-profit organizations in the 1990s have led to numerous calls for reform of both the tax code and other types of regulation of NFPs. More recently, there have been a number of hearings, investigations, and proposals on the governance and disclosure rules for NFPs. These recent efforts may lead to the adoption of new regulations and hopefully to improvements in governance.[2]

Our paper proceeds as follows. Section 2 illustrates the size of the NFP industry. In Section 3, we briefly address some of the most important governance arrangements in NFPs. In particular, we discuss the contribution of the papers in this volume to the literature on NFPs. For example, Core, Guay, and Verdi examine agency problems associated with excess endowments. Sansing and Yetman analyze the effect of the minimum distribution requirement and a dual excise tax rate regime enacted by Congress to regulate the behavior of private foundations. Petrovits investigates whether public companies strategically time contributions to their charitable foundations as a way of smoothing reported earnings. We then address in Section 4 how competition between for-profit and NFPs in service markets can act as a disciplining mechanism for NFPs. Section 5 offers a simple general equilibrium analysis of the effects of the corporate income tax exemption of NFPs. Section 6 concludes.

[1]A particularly striking example of a highly successful firm set up as a NFP and avoiding huge tax outlays is IKEA (see *The Economist*, May 29, 2006). Another recent incident that has attracted much attention in the financial press is T. Boone Pickens' very large contribution to the endowment of a college that is managed by his own hedge fund.

[2]Another trend toward improved efficiency in the not-for-profit sector is the emphasis on performance measurements and the adoption of governance benchmarks.

2. The size of the not-for-profit sector

Although the size of the sector is not known with certainty, a few examples highlight the importance of NFPs in the U.S. economy. The NFP sector was comprised of nearly 1.6 million organizations in 1998, with average asset holdings of approximately $2.9 million. By the end of 2001, the sector employed nearly 12.5 million people, or roughly 9.5 percent of total U.S. employment. In addition, the sector's average employment growth rate of 2.5 percent per year over the 1990s has exceeded that of the for-profit (1.8 percent) and government (1.6 percent) sectors.[3] Of the total employment in the NFP sector, 41.9 percent is in health services, 21.9 percent in education and research, 18.3 percent in social and legal services, 11.8 percent in religious organizations, 3.9 percent in civic, social, and fraternal organizations, 1.9 percent in arts and culture, and 0.3 percent in foundations.[4]

Between 1988 and 1998, NFPs, excluding religious organizations, saw the value of their financial holdings grow from $777 billion to $1.77 trillion.[5] Estimates for 1999–2001 indicate that contributions to charitable organizations increased by $50 billion over the period.[6] Although estimates are not available, it is likely that the recession that began in 2001 has also impacted contributions to charitable organizations. The resulting fiscal crisis has had an adverse effect on NFPs, as nearly a third of the sector's income is based on government contracts and grants. NFPs' income most likely has suffered further because of the poor performance of the stock market and its impact on household wealth and, in turn, on individual contributions. Finally, the sector has been hurt as corporate profits have declined somewhat in recent years, and corporate donations are generally a function of profits.

3. Agency problems and governance specific to not-for-profit organizations

Many observers have argued that NFPs are inefficiently run. Sometimes this inefficiency may even manifest itself in fraud and other abuse by management of these organizations (and philanthropies).[7] In response to these allegations, regulators and tax authorities have at times attempted to redress at least the most egregious abuses through regulatory intervention.[8]

[3]Nonprofit Almanac-Facts and Findings, Independent Sector, 2003 (http://www.IndependentSector.org).

[4]See footnote 3.

[5]"Snapshots", The Aspen Institute, November–December 2003.

[6]High-Engagement Philanthropy: A Bridge to a More Effective Social Sector. Venture Philanthropy Partners and Community Wealth Ventures, (2004).

[7]See for example, the history of scandal involving fraud and excessive compensation at NAACP, United Way, and Adelphi University (Frumkin, 2001; O'Connor, 1997; The Chicago Tribune, 1992). In addition, there were concerns about the Nature Conservancy's private benefits to board members and friends, as well as inflated land values aimed at getting larger tax deductions (Pearlstein, 2003). Also, it was alleged that the New Jersey Symphony Orchestra inflated instrument values to get a larger tax deduction (Pogrebin and Vogel, 2005). Finally, see Healy (2004) on fraud cases associated with the King Foundation and other philanthropies. Fremont-Smith (2004) has researched the lawsuits against directors and CEOs and found very little evidence that the court system has had an impact on governance of NFP firms.

[8]Scandals in the late 1990s led to regulations requiring the IRS information filing (Form 990) to be made publicly available (http://www.guidestar.org). They also led to the passage of legislation allowing the IRS to impose intermediate sanctions (in the form of fines) on NFPs that excessively compensate their employees (http://www.independentsector.org/programs/gr/intermediatesanctions.htm). More recently, the Senate Finance Committee held hearings on the Nature Conservancy. On June 22 and July 22, 2004, the SFC held hearings on Charity

The core governance problems of NFPs arise from their management having generally poor incentives and being shielded from the most potent disciplining devices in for-profit firms, like hostile takeovers, proxy fights, or even independent directors. Indeed, as others have noted (e.g. Glaeser, 2003), NFPs actually do not have owners. Founders and donors are not residual claimants like investors in for-profit firms. Also, the founding charter only loosely constrains the board and management of the NFP. For all intents and purposes all the control and ownership rights reside mostly within the self-perpetuating board.

The only countervailing constraint in NFPs that significantly limits potential abuse by management is the non-distribution constraint, which makes it much more difficult for management to engage in self-dealing. This non-distribution constraint is all the more powerful when it is tightly enforced by the IRS. Very large payments to management would typically be closely scrutinized by the tax authorities, although there have been some notable recent exceptions, in particular the outsized pay of the CEO of the NYSE, Richard Grasso.[9]

The non-distribution constraint has its own pernicious effects. If management and owners cannot pay themselves, perhaps the second-best course of action is to let capital accumulate without disbursing it to the ultimate beneficiaries. This is all the more tempting if high (tax-exempt) returns on investment can be obtained by shrewdly investing the endowment in hedge funds and other alternative investments. A larger endowment for the NFP ensures its survival and enhances its prestige. Management and the board thus benefit indirectly from excess conservatism in disbursements.

The papers in this volume directly focus on abuse in NFP organizations and the role of tax codes in the governance of NFPs. Core et al. (2006) examine whether there are agency problems when NFPs hold excess endowment assets. They base their study on the literature that explores agency problems related to cash holdings in for-profit firms (e.g. Jensen, 1986). Core et al. argue that cash-related agency problems are potentially exacerbated in NFPs because NFPs have no residual claimants with strong monitoring incentives.

Core et al. examine endowments in a broad sample of NFPs over the period from 1992 to 2001. They estimate a firm's excess endowment, and the excess can mean: (1) an endowment that is optimally larger in anticipation of firm-specific growth opportunities; (2) an endowment that is optimally larger because of superior firm-specific monitoring; or (3) an endowment that is sub-optimally larger due to firm-specific agency problems. Their empirical examinations can distinguish between these explanations. Inconsistent with large endowments anticipating greater firm-specific growth opportunities, Core et al. find firms with excess endowments maintain them for several years and firms with persistent excess endowments do not exhibit higher growth in program expenses or investments.

Core et al. then conduct tests to distinguish between firm-specific monitoring and agency problems as potential explanations for excess endowments. They observe that the program expense ratio is lower for firms with excess endowments, consistent with the prediction of greater agency problems in firms with excess endowments. Further, they document a

(*footnote continued*)

Oversight (http://www.senate.gov/~finance/sitepages/hearings.htm). The staff discussion document (http://www.senate.gov/~finance/hearings/testimony/2004test/062204stfdis.pdf) is likely to be the basis for new legislation. Attorneys-General of some states (e.g. NY, CA, and MA) have argued that Sarbanes-Oxley be extended to NFPs. See (http://www.independentsector.org/issues/sarbanesoxley.html) for potential applications of Sarbanes-Oxley to NFPs.

[9]See Dan Ackman "Dick Grasso And The Company He Keeps", *Forbes Magazine*, May 7, 2003.

positive association between excess endowments and compensation supporting the agency explanation. Overall, they find that excess endowments are associated with greater agency problems.

Sansing and Yetman (2006) examine the effect of tax laws enacted by Congress to regulate the behavior of private foundations: *the minimum distribution requirement* and *a dual excise tax rate regime* on the accumulation of funds and distributions by foundations. The question is whether or not these proposals sanctioned into law have influence on the governance and conduct of private foundations. The minimum distribution requirement forces the entities to spend no less than five percent of their funds on charities. The authors examine the tax returns of nearly 3800 foundations. They document that the minimum requirement seems to be binding as slightly over half of their sample distribute funds close to the five percent minimum. Sansing and Yetman document that those foundations that distribute above the required minimum, pay higher compensation and management fees and are growing faster. The findings suggest that foundations do not alter their behavior because of the dual tax rate structure, although larger foundations are more likely to be beneficiaries of the dual rate. The authors further suggest that tax laws affect private foundations' conduct and governance.

Petrovits (2006), examines the intersection of for-profit and NFP activities. She investigates whether public companies strategically time giving to their charitable foundations in order to beat earnings benchmarks. Although corporate-sponsored foundations are legally separate entities, they maintain close ties to their parent companies. Corporate managers actually control the foundations and can use them to achieve the firms' operating and financial reporting objectives. The results are consistent with the view that foundation giving is one device in a portfolio of discretionary choices that managers can use to achieve earnings targets.

Despite the often discussed potential inefficiencies and weaker governance structures of NFPs, there is little evidence on the relative inefficiency of the sector compared with for-profit firms. What is clear is that both sectors respond to the same economic forces. For example, the past recession catalyzed a significant number of consolidations in both sectors.[10] The parallel in restructuring activities in both sectors is particularly intriguing, given the absence of well-defined capital markets and, to some extent, asset markets in the not-for-profit sector.

Ultimately, a more fundamental question to ask is what is the objective of NFP organizations? Given the deep rooted and historical differences in governance of the two forms of organizations, it may be that the inefficiency of the NFP sector is mainly due to the substantial government tax subsidy, a topic that we will discuss in Section 4.[11]

4. Competition by for-profit firms as a disciplining device

As discussed above, services offered by NFPs are often also sold by for-profit enterprises. This raises the possibility that at least for this range of activities, competition

[10]Bradley et al. (2003) question whether the sector would be much more efficient if it were more consolidated. Consolidations are occurring in sectors, such as hospitals, where there are financial pressures and for-profit competition.

[11]We know little about the effect of personal taxation on entrepreneurs' and founders' incentives and, in turn, on governance.

in product and service markets between for-profits and NFPs is an effective disciplining mechanism for poorly performing organizations of either form. In these situations, improvement in governance in one sector is likely to improve the governance and in turn the efficiency of the other sector. However, some of the activities in the NFP sector are unique, and sound governance practices in these cases are even more critical.

We illustrate here how competition by for-profit firms can reduce managerial slack in NFP firms by using a simple example of competition in a product market (say, the healthcare market) adapted from Hart (1983). Thus consider a market with m NFP firms and n for-profit firms. These firms may be more or less efficient and more or less well run. We capture differences in efficiency by letting firms be either high-cost type firms (c_H) or low-cost type firms (c_L), with $c_H > c_L$. A firm is well run if its management puts in high effort to reduce costs.

For simplicity, we only allow for two levels of effort $e \in \{0, 1\}$. When $e = 1$ (that is, when management puts in high effort) unit costs of production are reduced from c_i to $c_i - 1$, where $i = L, H$. In that case the manager incurs a private cost $\psi > 0$ per unit of output produced. When $e = 0$ on the other hand, management does not reduce costs and also does not incur any disutility cost of effort.

We consider two extreme cases, one where cost shocks are identically and independently distributed and the other where cost types are perfectly positively correlated.

4.1. Independent cost draws

Suppose that any firm, whether NFP or for-profit, may be a high cost firm with probability p, and a low-cost firm with probability $(1-p)$. To keep the analysis simple we shall consider a simple price competition game *á la Bertrand* (see, e.g. Tirole, 1988) but the qualitative results obtained in this special setting extend to much more general product-market competition models.

The timing of the game is as follows: (i) nature draws all cost types, which are publicly observed by all firms; (ii) firms set prices; (iii) consumers buy from the lowest price firm. If there is more than one firm charging the same lowest price then consumers first go to the lowest-cost firms among those firms setting the minimum price; (iv) firm managers decide whether to put in high effort to minimize costs or not once they know whether they have any customers to serve or not. We shall denote market demand by $D(P)$ and assume that demand is strictly decreasing in price P. We also make the following additional assumptions:

(1) All firms can produce at most one unit of output, and the total number of firms $(m+n)$ is such that

$$(m + n - 1) > D(c_H - 1 + \psi).$$

(2) It is efficient for managers to put in high effort, so that $1 > \psi$.
(3) NFP managers get paid a wage $w > 0$ as long as their firm is solvent. Otherwise they lose their job and get zero.
(4) For-profit firms are run by owner-managers who retain any profits they make.

Under the first of these assumptions, there would be at least one firm unable to sell its output if the minimum price P is greater than $c_H - 1 + \psi$. Therefore, any Bertrand–Nash

equilibrium involves equilibrium prices that are no greater than $c_H - 1 + \psi$. In addition, given our assumptions on timing, the Bertrand–Nash equilibrium will be such that $P = c_H - 1 + \psi$ whenever the number of low-type cost firms is less than $D(c_H - 1 + \psi)$.

For the purposes of our analysis we only need to focus on this situation. For this equilibrium price, all for-profit firms put in high effort and set $e = 1$. Indeed, if they are high-cost types they just break even (if one includes their effort cost in total costs) by serving a customer at price $P = c_H - 1 + \psi$, otherwise they make losses serving the customer. If they are low-cost types they make an incremental profit of $1 - \psi$ if they put in high effort.

Similarly, all NFP high-cost types put in high effort. Otherwise, their firms would suffer losses and their managers would lose their jobs. On the other hand, low-cost types can sell at a profit whether they put in high effort or not, whenever $c_H - c_L > 1$. And since NFP managers do not get the benefit from increasing profits they are better off not putting in high effort. This is where the lack of high powered incentives and the lack of monitoring by owners in NFP firms results in inefficiencies. These inefficiencies could be mitigated somewhat if there was a higher number of for-profit firms in the market. But note that it is only when the proportion of low-cost for-profit firms is high enough that product-market competition exerts some form of discipline on the low-cost NFP firms.

4.2. Correlated cost draws

On the other hand, when cost-types are perfectly positively correlated there can only be two possible outcomes: either all firms have high costs or all have low costs. In either case, it should be easy to see that the presence of for-profit firms in the market perfectly disciplines the NFP firms. Basically, all firms have to put in high effort to survive. If, on the other hand, the market was entirely composed of NFP firms one Bertrand–Nash equilibrium would be for all these firms to set price $P = c_i$ and not to put in any effort. To see that this is an equilibrium outcome, observe that the best response for any given NFP firm to this strategy by all other firms is to simply match the price and not to put in any effort. If the manager were to put in high effort he would raise the profit of his firm but he would not benefit from this increase in profits. He would receive the same wage w and also incur the cost ψ.

This simple analysis illustrates how competition by for-profit firms in product markets can serve as a disciplining device for NFP firms. But the effectiveness of this discipline depends to a large extent on whether firms share similar cost structures. It is only when they do, that the discipline is likely to be significant. Also, this analysis ignores the tax advantage of NFPs. If, because of their tax treatment all NFPs are effectively low-cost types, while for-profit firms are high-cost types, then competition by for-profit firms will have little or no disciplining effect.

5. What is the rationale for exempting not-for-profit firms from federal corporate income tax?

The tax exemptions that NFPs enjoy are generally seen as a critical underpinning of charitable giving in the U.S. and an important factor behind the growth and prosperity of the NFP sector. Although more prosperous NFPs are generally seen as a good thing it is also true that the tax exemptions NFPs benefit from involve an opportunity cost. An unavoidable basic economic question therefore is what justifies this tax exemption. Do

the benefits of the exemption generally outweigh the costs? At what point is the exemption no longer warranted?

Of course, some commentators would argue that all firms, whether NFP or for-profit should be exempt from corporate income tax, but since in all likelihood the corporate income tax is not going to be abolished in the foreseeable future, the more pertinent question is why the NFP sector should be exempt.

Interestingly, the association of the tax exemption with the NFP sector is so deeply ingrained that there have been very few studies addressing this important policy issue. Among the most recent analyses of this issue is the important article by Hansmann (1981) published almost a quarter century ago. This article begins by noting that there is no clear rationale for the exemption in the preceding literature, and although it then proceeds to offer a justification based on the potential under-provision of capital to the NFP sector in the absence of an exemption, it concludes by noting that this new justification is far from clear-cut.[12]

Hansmann argues that an analysis of this issue is increasingly relevant given that: "*the nonprofit sector represents a substantial and growing share of the national economy (the best data available, which are not very good, suggest that the nonprofit sector today accounts for roughly 3% of GNP, compared to just over 1% fifty years ago)*."

Remarkably, over the next twenty-five years or so there has been no other major study questioning the wisdom of the tax exemption even though the NFP sector has continued to grow consistently and rapidly over this period as we have highlighted above.

Today, the nonprofit sector approaches 6% of GNP or more, depending on how one measures the sector.[13]

In this section we pursue Hansmann's analysis further by considering the desirability and effects of a tax exemption in a simple general equilibrium framework with two sectors. As others have argued before, we take as a basic premise the idea that some services may be under-provided in a competitive market equilibrium because consumers' ability to pay for those services may not adequately reflect their needs or willingness to pay. We shall take healthcare as an example of such services, but our analysis applies to any sector where there is likely to be a substantial discrepancy between the social value of a service and individual agents' ability to pay for it. We do not see a compelling rationale for a tax exemption unless there is likely to be under-provision of services in some sectors in competitive equilibrium.

Consider an economy with two sectors, a healthcare sector and the rest of the economy, which we label as the non-healthcare sector. What distinguishes the healthcare sector is that the social value of capital K, $V_H(K)$ is strictly greater than agents' ability to bid for that capital, $A_H(K)$: $V_H(K) > A_H(K)$, while in the non-healthcare sector agents' ability to pay is the same as their willingness to pay, $V_{NH}(K) = A_{NH}(K)$ (it is not important for the argument that ability and willingness to pay coincide in that sector; all that is required is that the gap between the two is smaller than in the healthcare sector). Assuming that there is a fixed aggregate stock of capital in this economy of K_T, we represent the socially optimal allocation of capital to the healthcare sector $K^* < K_T$ in Fig. 1.

[12]See Hansmann (1990) and Hansmann (2000) as well as White (2001) for a more recent discussion of tax issues in NFPs.

[13]Bureau of Economic Analysis, 2005.

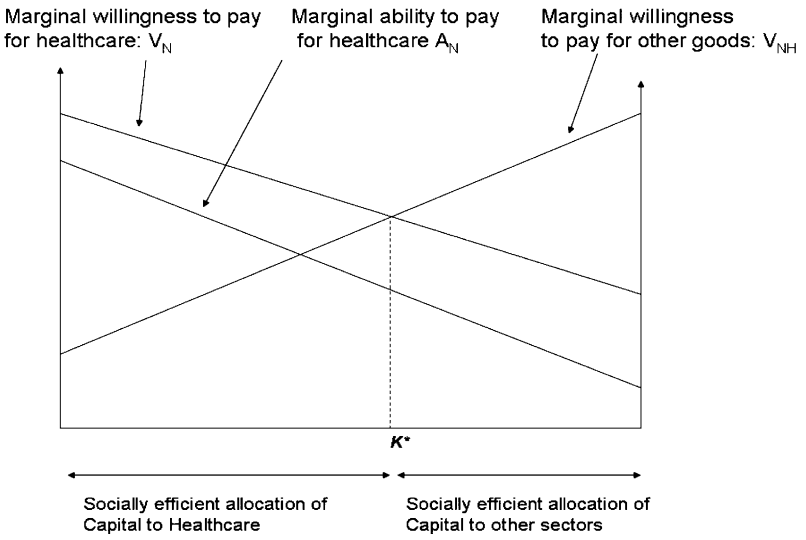

Fig. 1. Socially efficient allocation of capital.

The left-hand vertical axis measures, respectively, the willingness and ability to pay for capital in the healthcare sector, $V_H(K)$ and $A_H(K)$. Capital allocated to the healthcare sector, K_H, is measured by the distance from the left-hand origin. These schedules are downward-sloping as the marginal social value of an additional unit of capital is assumed to be decreasing. The fact that these schedules are linear is not relevant for the basic argument. The right-hand axis measures the willingness to bid for capital in the rest of the economy, $V_{NH}(K)$. Note that capital going to the non-healthcare sector, K_{NH}, is measured by the distance from the right-hand origin, K_T, and the schedule is also downward-sloping as an increase in capital allocated to the sector is reflected by a move away from the right-hand origin towards the left-hand origin.

Note that Fig. 1 represents an allocation of capital to the two sectors, where there is no capital left idle in the economy. The allocation K^* (or equivalently $K_T - K^*$) is socially efficient since for that allocation the marginal social values of capital in the two sectors is equalized.

Comparing the socially optimal allocation K^* to the equilibrium allocation K^e represented in Fig. 2 we observe that in equilibrium there is under-provision of capital to the healthcare sector due to the fact that agents' ability to pay for healthcare does not fully reflect the social value of healthcare. There are many reasons why one should expect $V_H(K)$ to be higher than $A_H(K)$. Individuals may be wealth-constrained and may not be able to borrow in efficient capital markets. They may be underinsured. They may also not be well placed to assess their private benefits of healthcare. Finally, their own good health provides a positive externality on society, which they cannot easily internalize. In any case, following many other commentators we take as a basic justification for a tax exemption the fact that $V_H(K) > A_H(K)$.

We argue, however, that if $V_H(K) > A_H(K)$ justifies some form of differential tax treatment of the health-care sector in order to bring about a more efficient allocation of capital, it is far from clear that this differential tax treatment should take the form of a

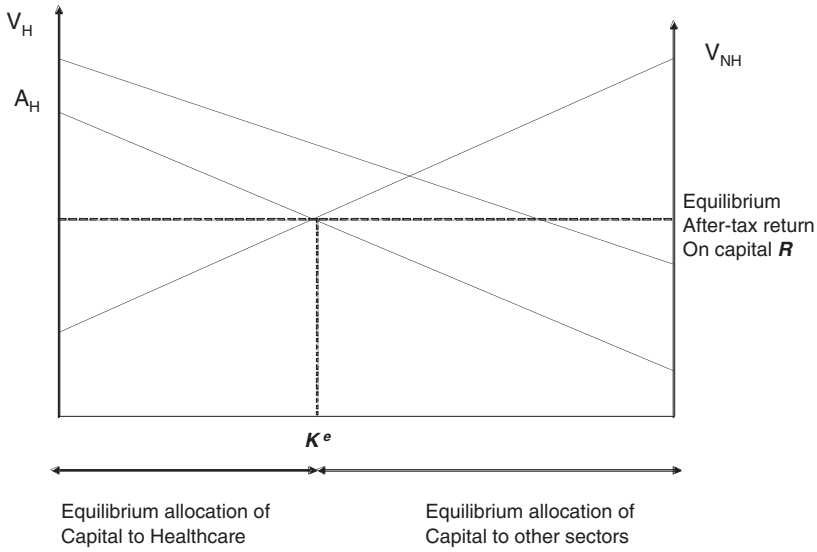

Fig. 2. Equilibrium allocation of capital.

corporate income tax exemption for non-profit organizations. For one, NFPs may not necessarily be operating only in the healthcare sector. For these NFP organizations the exemption may actually increase distortions in capital allocation.

Even abstracting from the possibility that NFP firms might be operating in the non-healthcare sector we point out in Figs. 3 and 4 that as long as there is co-existence of NFPs and for-profit firms in the healthcare sector the only effect of a tax exemption on NFPs is to transfer a rent to the NFP sector without any effect on the overall allocation of capital to the two sectors. In other words, the effect of the exemption is to displace for-profit firms by NFPs at the margin in the health-care sector, but without increasing the overall allocation of capital to the healthcare sector. Thus, the exemption is purely wasteful in this situation, as it reduces the overall tax base and imposes a higher tax burden on all other tax payers without providing any benefit in terms of a more efficient allocation of capital. To the extent that NFPs are concentrated mostly in healthcare and education, two sectors in which they compete along with for-profit firms, this wasteful subsidy could be substantial.

The tax exemption would only result in a more efficient allocation of capital if the entire healthcare sector was taken over by NFPs. In that extreme case the entire sector would expand as a result of the exemption. Conceivably, the growth of the NFP sector could be such that eventually the entire healthcare sector is covered by NFPs, but until we reach that point the exemption will have no socially beneficial effects. In addition, if the ultimate goal is to increase the allocation of capital to the healthcare sector then a more efficient and direct way of targeting the exemption would be in the form of investment tax credits targeted to investments in the healthcare sector. As Hansmann (1981) and others have argued before, there is no reason to only target subsidies to the NFPs in the healthcare sector.

One potential concern with our analysis might be that it relies on an implicit assumption of a fixed aggregate stock of capital and a general scarcity of capital in the economy.

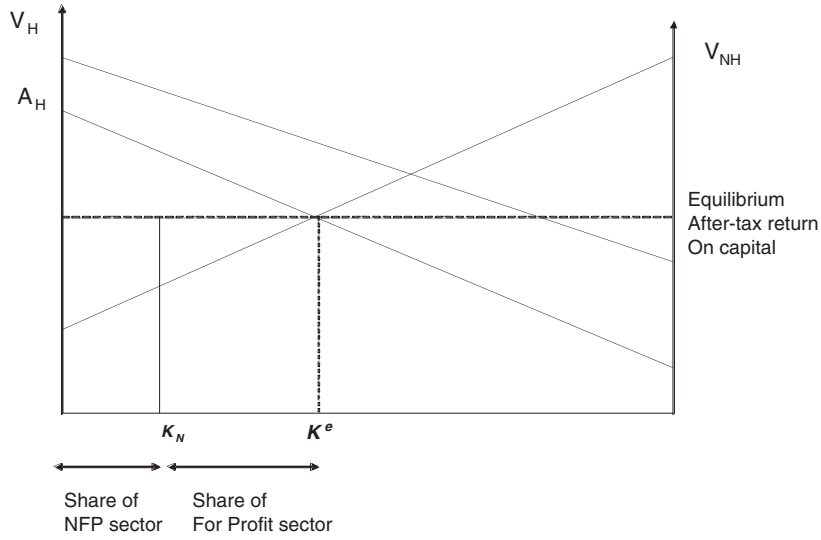

Fig. 3. Share of NFP sector with no tax exemption.

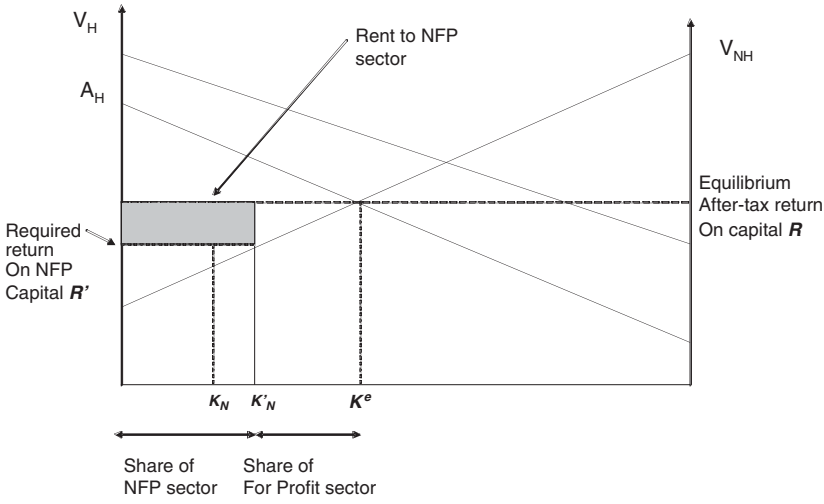

Fig. 4. Share of NFP sector with a tax exemption.

In a more general setting one might speculate that the corporate income tax exemption would bring in new previously 'idle' capital as the exemption would raise the rate of return on capital allocated to the NFPs.

We depict an equilibrium with 'idle' capital in Fig. 5. As should be clear from this figure, our argument actually extends to this setting. Indeed, new idle capital would be drawn into the healthcare sector only if the marginal firm was a NFP. That is, again, only if the entire sector is covered by NFPs.

Our simple general equilibrium analysis here suggests that the rationale for a corporate income tax exemption for NFP organizations is even weaker than suggested by Hansmann

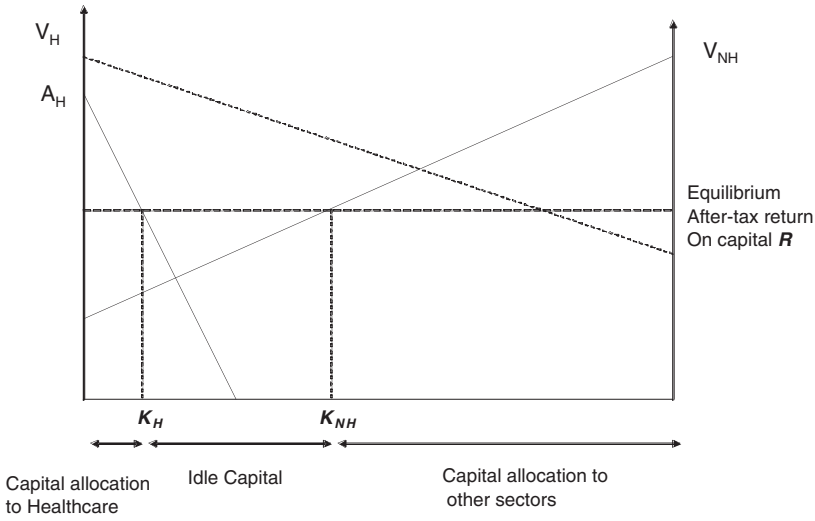

Fig. 5. Equilibrium with idle capital.

(1981). Even if one allows for his rationale, namely raising the level of capital in the NFP sector, it is far from clear that a more socially desirable allocation of capital would be achieved in sectors where NFPs compete along with for-profit firms. Worse still the tax exemption also has the effect of relaxing price competition in product markets between NFPs and for-profit firms, thus permitting more managerial slack.

In addition, it is not at all obvious that an exemption to NFPs is a superior instrument than a more direct investment tax credit for investments in the healthcare sector. A recent Congressional Budget Office study (2005) concluded that a lifting of the exemption of the corporate income tax for NFPs would be unlikely to generate substantial tax revenues. The study, however, does not undertake a more systematic cost–benefit analysis and does not explore the effects of a substitution of the NFP corporate income tax exemption for other tax instruments, such as investment tax credits. Also, the study does not take into account the potentially large effects of the exemption on wasteful tax-avoidance activities. Given the sustained growth rate of the NFP sector, and the substantial size the sector has reached, a more in-depth analysis of this issue is long overdue.

6. Conclusion

In this brief introduction we have reviewed some of the most salient statistics concerning the NFP sector today and discussed some governance issues specific to NFPs. We have further argued that perhaps the main factor behind the relative growth of the NFP sector, namely the corporate income tax exemption that NFPs benefit from, has little grounding in theory. Given the size the sector has reached and the rapid growth of the endowments of the largest NFPs, we believe that it is high time for a more in depth evaluation of this exemption.

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