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The Case Against For-Profit Charity

Benjamin Moses Leff[*]

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I. INTRODUCTION

In 2004, Google Inc. ("Google") announced to its shareholders that it would commit approximately one percent of the value of its equity to charitable endeavors.[1] It formed a 501(c)(3) corporate charity, the Google Foundation, to carry out these activities.[2] Subsequently, Google announced that it would not pursue the majority of its charitable work through its charitable foundation, but instead would act through a *for*-profit operating division, Google.org.[3] The federal tax code has granted tax benefits to charitable organizations for almost a hundred years.[4] Generally, an organization must meet two fundamental requirements to receive these tax benefits. First, it must be "operated for a good purpose"; and second, it may not distribute its profits to any private persons.[5] Google decided that it was worthwhile to forego the charitable tax benefits that may be available in order to pursue the first requirement (operating for a "good purpose") without being constrained by the second (refraining from distributing profits). This decision was met with a mixed reaction in the press and in the scholarly community.[6] But at least some scholars re-

[1] Google Inc., Amendment No. 9, Registration Statement (Form S-1), at A-14 (Aug. 18, 2004), *available at* http://www.sec.gov/Archives/edgar/data/1288776/000119312504142742/ds1a.htm#toc59330_25a

[2] *Id.*

[3] Shruti Rana, *From Making Money Without Doing Evil to Doing Good Without Handouts: The Google.org Experiment in Philanthropy*, 3 J. BUS. & TECH. L. 87, 87–88 (2008).

[4] Generally, this Article discusses "charitable" organizations, which refers to those organizations devoted to functions that would enable them to meet the purposes requirement of § 501(c)(3) of the federal income tax code. *See* 26 U.S.C. § 501(c)(3) (2006). "Tax benefits" include the exemption of income for charitable organizations, which was part of the Income Tax Act of 1913, and the deduction for contributions to charitable organizations, which was enacted in 1917. Revenue Act of 1913, 38 Stat. 114, 172 (codified as amended in scattered sections of 26 U.S.C.); War Revenue Act of 1917, ch. 63, § 1201(2), 40 Stat. 300, 330 (codified at 15 U.S.C. §§ 71–77 (2006)).

[5] *See* Roger Colinvaux, *Charity in the 21st Century: Trending Toward Decay*, 11 FLA. TAX REV. 1, 12–13 (2011) ("The two core statutory requirements of the 1913 exemption are unchanged: charitable exemption still (of course) requires a 'good' purpose (and in general statutory law does not attempt to quantify the purpose); and the exemption still is conditioned on the private inurement restriction."). Since 1913 a host of additional restrictions have been placed on charitable organizations, but these two remain fundamental to all charities. *See, e.g.*, *id.* at 11–13.

[6] *See, e.g.*, Victor Fleischer, *Urban Entrepreneurship and the Promise of For-Profit Philanthropy*, 30 W. NEW ENG. L. REV. 93, 100 (2007); Katie Hafner, *Philanthropy Google's*

acted favorably, arguing that the restrictions imposed on charities under current law—most fundamentally the so-called "non-distribution constraint," which is what makes a charity "nonprofit"—unnecessarily impede charitable work.[7]

The most dramatic proposal came from Anup Malani and Eric Posner, who argued that current law should be changed. Instead of requiring charities to assume a nonprofit form as a precondition of receiving tax benefits, such tax benefits should be available to for-profit firms if they operate for a "charitable" purpose.[8] Malani and Posner asked: If a for-profit operating division of a for-profit corporation could do the very same good works that a nonprofit charity could do—in Google's case develop products that promote worldwide health and energy sustainability—then what is the justification for denying tax benefits to it?[9] Absent a compelling justification for "coupling" tax benefits with the non-distribution constraint, should not the two things be "de-coupled"?[10] Malani and Posner examine what they identify as the leading justifications for tax subsidies in the charitable sector and argue that none of them successfully justifies reserving such benefits exclusively for nonprofit charities, denying them to so-called for-profit charities.[11]

Way: Not the Usual, N.Y. TIMES, Sept. 14, 2006, at A6; Jennifer Lee, *A Charity with an Unusual Interest in the Bottom Line*, N.Y. TIMES, Nov. 13, 2006, at F1. Among other things, once Google has chosen to forego tax-exempt status, there is arguably nothing in the law to keep it to its promise to devote its funds to a "good purpose."

[7] *See, e.g.*, Christopher Lim, *Google.org, For Profit Charitable Entity: Another Smart Decision by Google*, 17 KAN. J.L. & PUB. POL'Y 28 (2007); Rana, *supra* note 3, at 93; Dana Brakman Reiser, *For-Profit Philanthropy*, 77 FORDHAM L. REV. 2437, 2454 (2009).

[8] Anup Malani & Eric Posner, *The Case for For-Profit Charities*, 93 VA. L. REV. 2017, 2065 (2007); *see also* M. Todd Henderson & Anup Malani, *Corporate Philanthropy and the Market for Altruism*, 109 COLUM. L. REV. 571, 607 (2009) ("[T]he government should eliminate tax discrimination between producers of altruism."). More than a decade before Malani and Posner's article appeared, Evelyn Brody ominously proposed that, "unless nonprofits can more sharply distinguish themselves from for-profits . . . society might prefer to subsidize charitable and other social outputs produced by all organizations rather than subsidize nonprofits based on their organizational form." Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Form*, 40 N.Y.L. SCH. L. REV. 457, 461 (1996).

[9] Malani & Posner, *supra* note 8, at 2031.

[10] *Id.* at 2029.

[11] *Id.* at 2029–56. The federal tax benefit that this Article focuses on is the deductibility of contributions, and therefore consideration of exemption from the corporate tax is beyond the scope of this Article. Malani and Posner argue that contributors to for-profit firms that do "good work" should be permitted to deduct their contributions. *Id.* at 2029. But instances of contributions to for-profit firms doing charitable work are relatively rare (though not unheard of). Malani and Posner propose that, in addition to a deduction for "pure" contributions, a purchase of a consumer good from a firm that does good deeds should result in a partial deduction to

It is not just Google that has questioned whether the nonprofit form is the best way to structure firms that purport to promote the common good. In just the last few years, a growing number of states have enacted legislation to enable "hybrid" entities to be created: for-profit firms devoted to more than just a financial bottom line.[12] These hybrid legal forms are justified at least partially as a response to the overly restrictive nature of nonprofit law generally, and the "non-distribution constraint" particularly.[13] So far, none of these states has enacted tax benefits for the new hybrid entities, but it is likely that tax benefits are not far off.[14]

Malani and Posner's article provides a potential justification for future reformers' intent to re-fashion laws restricting the ability of charitable organizations to take a profit. While several commentators have criticized Malani and Posner's article on various grounds,[15] none has systematically offered a counter-theory explaining why the "cou-

the extent that the purchase price exceeds the "quality adjusted price" of goods with no charity component. *See id.* at 2063. These purchases of "good works" goods are presumably more common than outright donations to for-profit firms, but they implicate valuation issues that are beyond the scope of this Article.

[12] To date, eight states have passed legislation permitting the creation of a "low-profit limited liability company" ("L3C"): Michigan, Vermont, Illinois, Wyoming, Utah, Louisiana, North Carolina, and Maine. 805 ILL. COMP. STAT. 180/1-26 (2010); LA. REV. STAT. ANN. § 12:1302 (2010); ME. REV. STAT. tit. 31, § 1611 (2011); MICH. COMP. LAWS § 450.4102 (2010); N.C. GEN. STAT. § 57C-2-01 (2011); UTAH CODE ANN. § 48-2c-412 (West 2009); WYO. STAT. ANN. § 17-29-102 (West 2010). Legislation permitting the creation of so-called "benefit corporations" has passed in seven states: California, Hawaii, Maryland, New Jersey, New York, Vermont, and Virginia. *State by State Legislative Status*, BENEFIT CORP. INFO. CENTER, http://www.benefitcorp.net/state-by-state-legislative-status (last visited Apr. 24, 2012). Similar legislation is pending in eight others: Colorado, Louisiana, Illinois, Michigan, North Carolina, Pennsylvania, South Carolina, and Washington D.C. *Id.* In addition, California has enacted the "flexible purpose corporation." *See* S.B. 201, 2011—2012 Gen. Assem., Reg. Sess. (Ca. 2012). For an overview of hybrid social-enterprise legal forms, see Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337 (2009).

[13] *See, e.g.*, Dana Brakman Reiser, *Blended Enterprise and the Dual Mission Dilemma*, 35 VT. L. REV. 105, 106 (2010) (explaining that "blended" legal forms have arisen partially because traditional charities are prevented from distributing their profits to shareholders).

[14] Philadelphia has recently become the first jurisdiction in the country to enact a tax benefit for "benefit corporations," even though Pennsylvania has not yet enacted a statute permitting their creation. *See* PHILADELPHIA., PA., BUSINESS PRIVILEGE TAXES, PHILA. CODE 19-2600 (2009).

[15] *See, e.g.*, Rob Atkinson, *Response: Keeping Republicans Republican*, 88 TEX. L. REV. 235 (2010); *see also* Victor Fleischer, *"For-Profit Charity": Not Quite Ready for Prime Time*, 93 VA. L. REV. IN BRIEF 231 (2008); Brian Galle, *Keep Charity Charitable*, 88 TEX. L. REV. 1213 (2010); Mitchell A. Kane, *Decoupling?*, 93 VA. L. REV. IN BRIEF 235 (2008); David M. Schizer, *Subsidizing Charitable Contributions: Incentives, Information, and the Private Pursuit of Public Goals*, 62 TAX L. REV. 221, 254–55 (2009).

pling" of the charitable deduction with the non-distribution constraint is good policy. This Article attempts just that. In doing so, it focuses on the so-called "agency theory."[16] Malani and Posner argue that the "agency theory" fails to justify reserving tax benefits for nonprofits.[17] Because it is focused on the donor's choice of charitable provider, the traditional "agency theory" supports a legal regime that does not discriminate between nonprofit and for-profit charities.[18]

This Article attempts to expand the "agency theory" for the first time in such a way as to explain why it is reasonable for the government to require that tax benefits be provided only to *nonprofit* firms that provide charitable services. Even if meeting its objectives as "efficiently" as possible is the only concern of the government, it is justified in providing tax benefits only to nonprofit providers of charity. In their article, Malani and Posner imagine a transaction between someone who provides money to support charitable activities (a donor) and someone who provides the labor and expertise (an entre-

[16] Posner and Malani use the term "agency theory" to describe a theory advanced by Henry Hansmann, with respect to nonprofit organizations, in a series of works in the early 1980s. *See, e.g.*, Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835 (1980) [hereinafter Hansmann, *Role*]; Henry Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497 (1981) [hereinafter Hansmann, *Reforming*]. Other works also discuss the application of the "agency theory" to nonprofit organizations. *See, e.g.*, Brody, *supra* note 8; Edward L. Glaeser & Andrei Shleifer, *Not-for-profit Entrepreneurs*, 81 J. PUB. ECON. 99 (2001); Robert A. Katz, *Can Principal-Agent Models Help Explain Charitable Gifts and Organizations?*, 2000 WIS. L. REV. 1 (2000); Geoffrey Manne, *Agency Costs and the Oversight of Charitable Organizations*, 1999 WIS. L. REV. 227 (1999). *See generally* THE ECONOMICS OF NONPROFIT INSTITUTIONS: STUDIES IN STRUCTURE AND POLICY (Susan Rose-Ackerman ed., 1986) (discussing economic analysis of nonprofit organizations, including the agency theory).

[17] Malani & Posner, *supra* note 8, at 2034–41. I use the term "agency theory," and the related terms "agent" and "principal" cautiously. The theory called "agency theory" in Malani and Posner's article is really a theory about transaction costs, not agency costs because the costs incurred are those between two actors who do not legally enter into an agency relationship. The gist of the argument, however, is essentially the same as the reasoning that underscored Ronald Coase's seminal work, *The Nature of the Firm*—that transaction costs are sometimes high enough to drive rational market participants to create relationships unlike those that would be created by participants in classical theoretical markets (with low transaction costs). Ronald Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937).

[18] Hansmann's purported justification for the tax exemption has generally been called the "capital access theory," which does link the justification for tax benefits to the non-distribution constraint. *See* Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54, 75 (1981) [hereinafter Hansmann, *Rationale*]. Rather than address Malani and Posner's critiques of the capital access theory, this Article provides an alternative justification for linking tax benefits to the non-distribution constraint—one that is derived directly from the agency theory. *See infra* Part III.

preneur).[19] They conclude that there may be many circumstances in which a donor and an entrepreneur agree that the best way for them to structure their transaction for the provision of charitable goods would be for the entrepreneur to pay herself a "for-profit" wage.[20] This Article explores in greater detail the concerns of these characters in the imagined transaction, and it finds that the situations in which it would be rational for these two characters to structure the provision of charitable goods in a for-profit form are likely rare. It then introduces a third character—the government—who seeks to subsidize the charitable activities provided by the donor and entrepreneur. The original contribution of this Article is that the current law—in which tax deductions are permitted to contributors to *nonprofit* firms conducting charitable activities but not to firms conducting *for*-profit charitable activities—is a rational response of the government to its own role in the transaction based on its evaluation of its own "agency costs."[21]

I should be clear: this Article is not a criticism of Google's choice to pursue its social agenda through a for-profit subsidiary. It is not a critique of recent "hybrid" legislation, such as benefit corporations or low-profit limited liability companies. There is nothing in this Article that questions whether for-profit entities should seek to advance the social good (they should), or whether the law should be made to accommodate these businesses (it should). Nor is there any critique of nonprofit charities seeking to expand their funding base to include revenue-generating businesses or to derive revenue from pursuing their social mission. The only question raised in this Article is whether the government is justified in providing tax benefits, specifically the deductibility of charitable contributions, *only* to *nonprofit* charities—those bound by the so-called non-distribution constraint. At the heart of this question is whether it is proper for the government to *withhold* tax benefits from organizations that compensate their management with a so-called "profits" interest in the firm.[22] I argue that it is.

[19] Malani & Posner, *supra* note 8, at 2027.

[20] *Id.* at 2038.

[21] Hansmann's justification focuses on charities' *exemption* from federal corporate income tax, while this Article focuses on the *deduction* provided to donors to 501(c)(3) charities. *See* Hansmann, *Rationale*, *supra* note 18, at 55–56 (explaining the focus on the exemption rather than the deduction).

[22] The "non-distribution constraint" prevents nonprofit organizations from using a "profits interest" in two ways: (1) to compensate management for its labor and (2) to compensate providers of capital for their investment. *See* Hansmann, *Role*, *supra* note 16 at 838. This Article discusses only the first restriction while leaving for an-

This Article is divided into three parts. Part II introduces the "agency theory" and critiques Malani and Posner's discussion of it. It finds that the agency theory predicts that donors and entrepreneurs will generally choose to structure their transactions through a nonprofit firm when the quality of the services they are seeking (the output of the transaction) is hard to measure or hard for the donor to observe. Malani and Posner propose that a "for-profit" compensation model may be preferable to the parties under certain circumstances,[23] but their analysis depends on their choice of a hypothetical in which the "for-profit" model actually replicates the benefits of the non-distribution constraint. Once the hypothetical is more fully explored, it becomes clear that donors who chose not to avail themselves either of the nonprofit form or some contractual substitute that replicates the effects of the non-distribution constraint would likely be creating a deeply inefficient transaction. This Part of the Article corrects Malani and Posner's discussion of the agency theory but does not explain why tax benefits should be legally "coupled" with the non-distribution constraint; it does not explain why donors to charitable for-profit firms should be denied a tax deduction.

Part III introduces the third character to the "agency-cost" analysis: the government. Because the government is providing a subsidy to the organization that provides "charitable" services, it is not only a regulator of providers of charity but also a market participant. Therefore, it has its own agency costs that are implicated in the transaction. This agency-cost analysis of the government's interest in providing tax subsidies appears to be novel in the literature. Prior work, including Malani and Posner's, has assumed that the government's interest is in facilitating the donor's and entrepreneur's interests in the transaction.[24] To the contrary, I argue that the government has its own interest: the provision of charitable goods. While this interest is often closely aligned with those of donors, it may sometimes conflict with the interests of both donors and entrepreneurs. In this Part, I generally propose that when the government wants to provide services under conditions in which the quality of these services is hard to measure or hard to observe, it acts reasonably when it provides tax subsidies *only* for those providers who are subject to the non-distribution constraint. Furthermore, the government is rational when it chooses to provide tax benefits only to organizations that

other day a full discussion of whether the prohibition a "profits" interest for investors is similarly justified by the "agency theory."

[23] Malani & Posner, *supra* note 8, at 2035–37.

[24] *See, e.g.*, *id.* at 2033–34.

agree to abide by a standardized set of rules relating to the non-distribution constraint. Since it is the government that has to monitor and enforce the constraint, it is obvious why it needs standardized rules rather than a plenitude of individually contracted agreements.

The final Part of the Article explores current law. Malani and Posner appear to be misinformed about what types of compensation are permitted under the law of nonprofit organizations. They categorize the possibilities as (i) a "profits" interest—not permitted to nonprofit organizations, and (ii) "fixed" compensation—required for nonprofit organizations.[25] In fact, there is a third option, (iii) "incentive-based" compensation. The current law of incentive-based compensation mostly permits nonprofits to solve, as best as possible, the concerns Malani and Posner have raised about the restricting effect of the non-distribution constraint on the compensation of charity entrepreneurs. Specifically, under current law, incentive-based compensation is permitted if some method of quantifying a particular output—other than "net profits"—is possible. The agency theory, as formulated in this Article, explains why current law draws the line between permissible and impermissible compensation arrangements in the proper place permitting certain incentive-pay arrangements because they are potentially efficient and prohibiting a pure profits-based arrangement because it is inefficient. The agency theory also suggests how the Internal Revenue Service (IRS) and legal reformers should be guided in further development of the law of charity management compensation.

II. THE AGENCY THEORY

Malani and Posner's central argument is that a for-profit organization generally operates more efficiently than a nonprofit organization.[26] The proposed reason that it operates more efficiently is that the opportunity to obtain profits incentivizes the people in control of the organization to increase their profits by providing whatever goods they provide more cheaply.[27] To the degree to which those in control of an organization can cut costs while still providing sufficiently high-quality goods, such cost-cutting increases the efficient production of those goods.[28] These efficiency gains can be split between the organi-

[25] *Id.* at 2018–19.
[26] *Id.* at 2055.
[27] *Id.* at 2027–29.
[28] *Id.*

zation and its customers, making everyone happier. Thus, the general rule is that financial incentives, like the ability to keep profits, encourage those in control of an organization to operate it efficiently to everyone's benefit.

Malani and Posner argue that this general rule holds for charitable organizations just the same as for other organizations.[29] If the owners of Starbucks are encouraged to provide a great cup of coffee in a cost-efficient manner by their ability to get rich from doing so, then why should the same incentives not improve the ability of an organization that seeks to improve the health of African children? Why not let providers of *charitable* goods keep their profits just like providers of regular consumer goods?

The leading answer to that question for the past thirty years has been Henry Hansmann's theory of "contract failure,"[30] which Malani and Posner refer to generally as the "agency theory."[31] The agency theory purports to explain why prohibiting the providers of *charitable* goods from personally keeping their profits will generally result in a more efficient structure than permitting them to keep them.[32] This is generally because it is very difficult or impossible for the people who pay for charitable goods to ascertain their quality, and so, the providers of such goods will be encouraged to increase their profits by reducing quality.[33] Therefore, to prevent providers of charity from increasing profits by reducing quality, funders of charity generally do not permit providers to take a profit.[34] In other words, the nonprofit form is usually the best way to assure the most efficient production of quality goods since it removes the incentive to decrease quality.

Malani and Posner are not primarily interested in whether the nonprofit form will *usually* result in a more efficient production of charitable goods. Rather, they argue that the people who pay for such charitable goods should be allowed to decide whether a for-profit or nonprofit structure would be best without interference from the government.[35] If there could ever be a situation in which the for-profit provider could provide charitable goods more efficiently, then it should not be prohibited from doing so. The fact that the government only provides tax benefits to nonprofit organizations that pro-

[29] Malani & Posner, *supra* note 8, at 2063.
[30] *Id.* at 2035 n.33.
[31] *Id.* at 2031.
[32] *Id.* at 2031–33.
[33] *See id.* at 2033–34.
[34] *See id.*
[35] Malani & Posner, *supra* note 8, at 2037.

vide charitable benefits puts the government's thumb on the scale and, in effect, discriminates against for-profit providers, even if those providers might sometimes provide charitable goods more efficiently.

Part III of this Article addresses why the government is justified in reserving tax benefits for nonprofit charitable providers only. It does so by expanding the agency theory to include the concerns of the government. But before the theory can be so expanded, it must be presented. This Part presents the agency theory as applied to the two primary participants in a transaction for charitable goods—the donor (who provides the money for the charitable goods) and the entrepreneur (who provides the labor and expertise for the production of those same goods).

A. *Henry Hansmann's Theory of "Contract Failure"*

1. Introduction to Hansmann's Theory

The term "agency theory," as used by Malani and Posner, refers to an explanation for the existence of the nonprofit form of organization generally associated with the work of Henry Hansmann from the early 1980s.[36] Hansmann argued that under certain circumstances, which he called "contract failure," purchasers of certain services would prefer to purchase those services from suppliers who agreed upfront to pay themselves *only* a reasonable wage and to devote any surplus value in the firm to advancing the mission of the firm.[37] Hansmann called this promise the "non-distribution constraint," and he considered it the defining characteristic of a nonprofit firm.[38] Hansmann called the purchasers of services in this context "patrons."[39]

Hansmann identified three situations in which "contract failure" was likely to occur, resulting in the creation of nonprofit firms.[40] First, nonprofits arise when patrons purchase services to be used by

[36] *See* Hansmann, *Role*, *supra* note 16, at 843–45. Of course, there is also a historical explanation for the development of nonprofit law. But I do not see historical explanations and functional ones as inherently at odds since each may simply explain the same phenomenon from a different perspective. The functional explanation serves as a more principled guide when considering proposed changes to existing policy.

[37] *See id.*

[38] *See id.* at 838.

[39] *See id.* at 841.

[40] Although Hansmann's theory is developed primarily in *The Role of Nonprofit Enterprise*, it is also discussed in other works. For an especially concise description of the three situations in which nonprofit firms are likely to arise, see Henry Hansmann, *Ownership of the Firm*, 4 J.L. ECON. & ORG. 267, 301–02 (1988).

unknown third parties.[41] His prime example of this type of transaction was CARE, an organization that solicits donations and uses the funds to provide relief to poor people in poor nations.[42] Hansmann called the providers of third-party services "donative" because the patron's payments are made voluntarily without any expectation of material quid pro quo, that is, in the form of a "donation" or "contribution."[43]

Second, "contract failure" may arise when patrons purchase so-called "public goods"— goods that exhibit the characteristics of being "nonrivalrous" and "nonexcludible."[44] A good is "nonrivalrous" when "it costs no more to provide the good to many persons than it does to provide it to one person."[45] It is "nonexcludible" if "once the good has been provided to one person[, then] there is no way to prevent others from consuming it as well."[46] Hansmann's example of this type of organization is listener-supported (or public) radio, because (i) it costs the same to broadcast over public airwaves to a single user or to multiple users, and (ii) it is impossible to restrict access to the transmission once it has been broadcast, so anyone who owns a radio can "free-ride" by listening to the shows without paying.[47] Nonprofits that

[41] *See* Hansmann, *Role*, *supra*, note 16, at 846–48.

[42] According to its website, CARE is one of the largest private international humanitarian organizations in the world, providing relief to the poorest communities. *About Care*, CARE, http://www.care.org/about/index.asp (last visited May 25, 2012). CARE provides relief in emergencies, but also attempts to build capacity in poor communities to fight poverty. *See id.* Hansmann describes CARE and similar organizations as primarily providing "relief to the poor and distressed." Hansmann, *Reforming*, *supra* note 16, at 505. For example, he describes CARE as providing "dried milk for hungry children in Africa." *Id.*

[43] *See* Hansmann, *Role*, *supra* note 16, at 840.

[44] *See id.* at 848.

[45] *Id.*

[46] *Id.*

[47] *See id.* at 849–51. Of course, Hansmann concedes that, while radio stations fit the definition of public goods with respect to their listeners, access to their listeners is potentially a private good. *See id.* at 850. Commercial radio and television operate by selling access to its listeners or viewers to advertisers, for whom this access is subject to rivalry (because each minute of additional ad time has costs) and is excludible (because ad time can be provided to one advertiser without another advertiser having access to it). In addition, it has been pointed out that technology now makes it relatively easy to turn access to radio or television into a private good because cable television is so established and satellite radio is becoming more and more widespread. *See, e.g.*, Mark Gergen, *The Case for a Charitable Contributions Deduction*, 74 VA. L. REV. 1393, 1444 (1988). Thus, in point of fact, public radio is a distinctly problematic example of a public good, although a case may be made that public radio is different from commercial radio in ways that make its support by advertisers or by cable or satellite providers sub-optimal.

provide public goods are also "donative" because the inability to prevent free riding again means that provision of the good cannot be conditioned on payment.[48]

Finally, contract failure may arise when patrons purchase certain services for their own use, if the quality of those services is especially difficult to evaluate.[49] Hansmann's examples of this type of nonprofit include organizations that provide healthcare, daycare, or nursing-home services.[50] He called these nonprofits "commercial" because their patrons paid for services in a transaction in which a specific good or service was provided in exchange for a set price.[51] Hansmann was interested in all three types of contract failure because he wanted to explain why nonprofits arise, and therefore, his theory needed to encompass as many types of nonprofits as possible.[52]

In this Article, however, I am most interested in the first and second type of contract failure: the ones that produce *donative* nonprofits. The reason for limiting my discussion is simple: the type of contract failure that occurs in a donative context is different in kind from the type of contract failure that occurs in a commercial context, and the distinctive nature of the donative context demands separate analysis. Because of this limitation, my thesis has to be similarly narrowed. I initially described my thesis as arguing that the government is justified in reserving *tax benefits* for nonprofit firms. However, this Article actually only addresses one of the two major tax benefits provided by the federal government—the deduction for contributions to charities.

In general, the federal government provides two major general tax benefits to nonprofits: the exemption from corporate tax[53] and the deduction from income tax for contributions to certain charitable nonprofits.[54] The *exemption* means that nonprofit organizations that qualify may earn revenue from their operations (fees for services) that escape taxation even when such revenue exceeds expendi-

[48] Hansmann, *Role*, *supra* note 16, at 849 ("Thus, economists generally have concluded that the private market is an inefficient means of providing public goods, and have looked to alternatives such as public financing as a better approach.").

[49] Hansmann, *Reforming*, *supra* note 16, at 506.

[50] *See id.* at 505–06.

[51] *See id.* at 502.

[52] *See id.* at 504.

[53] *See* 26 U.S.C. § 501 (2006).

[54] *See id.* § 170. Contributions to these same organizations may be deducted from the amount subject to federal estate tax and federal gift tax. *See id.* §§ 2055(a)(2), 2522(a)(2).

tures made to earn that revenue in the year at issue.[55] In addition, they may earn a return on their investments that escapes taxation. If the nonprofit had not been exempt from the corporate tax, then it would presumably pay tax on its net income, when such income is positive.[56]

The *deduction*, on the other hand, applies only to donations to nonprofit charities.[57] Here, the donor gets to reduce his taxable income by the amount of his contribution, subject to certain restrictions, and therefore no benefit is provided unless a donation is made.[58] Most observers consider the deduction a subsidy to the organization because the cost to the donor of making a donation is reduced.[59] The federal government provides other more targeted tax benefits to nonprofits, like favorable postal rates and the ability to issue tax-exempt bonds.[60] And of course, states often provide tax benefits that piggyback on federal classification of a nonprofit.[61] This Article confines itself to providing a justification for the federal income-tax *deduction* and ignores all these other tax benefits, and thus, in tax parlance, this Article only concerns entities classified under § 501(c)(3) of the Code—the classification that comprises most organizations that are entitled to receive deductible contributions.[62]

In some ways, the limitation of the justification to the deduction of contributions makes the task easier. As Hansmann has pointed out, "In the case of services . . . commonly provided by donative nonprofits, the need for a [nonprofit] organization is so obvious that for-

[55] *See id.* § 501.

[56] For a discussion of why the exemption from income sometimes constitutes a subsidy and sometimes does not, see Daniel Halperin, *Is Income Tax Exemption for Charities a Subsidy?*, 64 TAX. L. REV. 283 (2011). To the degree to which Hansmann's work deals with tax subsidies, it has focused on the exemption. *See* Hansmann, *Rationale*, *supra* note 18, at 55.

[57] *See* § 170.

[58] *See id.*

[59] *See* Gergen, *supra* note 47, at 1403; *see also* Galle, *supra* note 15, at 1215; Ilan Benshalom, *The Dual Subsidy Theory of Charitable Deductions*, 84 IND. L.J. 1047, 1057 (2009).

[60] *See* 39 U.S.C. § 3626 (2006) (favorable postal rates); 26 U.S.C. § 145 (2006) (tax exempt bonds).

[61] For a discussion of state tax benefits, see Evelyn Brody, *All Charities Are Property Tax-Exempt, but Some Charities Are More Exempt than Others*, 44 NEW ENG. L. REV. 621 (2010).

[62] The deduction is actually provided under § 170 of the Code, but the entity classification is provided under § 501(c)(3), and so I refer to such organizations as "501(c)(3) organizations" herein.

profit firms are virtually unheard of."[63] But thinkers like Malani and Posner have raised the issue of whether the charitable deduction should be extended to donations to for-profit firms, and it therefore deserves its own treatment.[64]

Hansmann argued that donative nonprofits arise because "either the nature of the service in question, or the circumstances under which it is provided, render ordinary contractual devices inadequate to provide the purchaser of the service with sufficient assurance that the service was in fact performed as desired."[65] That is, "Because the patron has no contact with the intended recipients, he or she would have no simple way of knowing whether the promised service was ever performed, much less performed well."[66] Because of this "contract failure," the patron wants to avoid the for-profit business form.[67] If the providers of the service could keep any profits not spent on providing the service, then "the owners of the firm would have both the incentive and the opportunity to provide inadequate service and to divert the money thus saved to themselves."[68] Thus, in situations of "contract failure," "the nonprofit form offers [patrons] the protection of another, broader 'contract'—namely, the organization's commitment, through its nonprofit charter, to devote all of its [net] income [after reasonable operating expenditures such as for compensation for its employees]—to the services it was formed to provide."[69]

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[63] *See* Hansmann, *Reforming*, *supra* note 16, at 508; *see also* Hansmann, *Rationale*, *supra* note 18, at 87 ("Donative nonprofits, almost by definition, typically provide services that are delivered to third parties or are public goods, and that as a consequence are attended by severe contract failure."). Anecdotes of contributions made to for-profit entities, however, are often recounted. For example, my wife and I recently made a contribution to our children's Montessori preschool, which is a for-profit sole proprietorship, as far as I know.

[64] As discussed *supra* note 11, Malani and Posner actually argue that purchasers of consumer goods from for-profit firms that "refrain[] from profitable activities that offend moral sensibilities" should be allowed a charitable deduction for the cost of the consumer goods they purchased "to the extent of [the firms'] charitable activities." Malani & Posner, *supra* note 8, at 2062–63. This argument is made much more forcefully by Henderson and Malani, who argue that the deductible amount should be that amount by which the cost of goods with a charitable component exceeds the cost of goods without a charitable component. Henderson & Malani, *supra* note 8, at 609–11. This proposal involves valuation issues beyond the scope of this Article.

[65] Hansmann, *Reforming*, *supra* note 16, at 504.

[66] *Id.* at 505.

[67] *See id.*

[68] *Id.* at 505.

[69] *Id.* at 507. Hansmann's theory is nicely summed up by Susan Rose Ackerman: "If the quality of output is difficult to measure, and if contracts for future delivery are difficult to enforce, the nonprofit form may act as a signal assuring people that quali-

Of course, there is a cost to patrons for choosing the nonprofit form.[70] Namely, "The curtailment of the profit motive that results from the non-distribution constraint can reduce incentives for cost efficiency . . . ."[71] Thus, there is a balancing of costs: on the one hand the cost of removing the strong incentives provided by the profit motive; on the other hand, the cost of monitoring and enforcing high-quality services, or (in the absence of monitoring) the risk that managers will reduce the quality of services in favor of profits. Hansmann suggests that "[o]nly when contract failure is relatively severe is it likely that the advantages of nonprofits as fiduciaries will clearly outweigh these corresponding disadvantages, and thus give the nonprofit firm a net advantage over its for-profit counterpart."[72]

To the degree to which it makes sense to describe Hansmann's contract failure theory as a "formula," the formula could be expressed as follows: *the nonprofit form will be chosen whenever the cost of monitoring and enforcing a specific level of product quality exceeds the gains that are expected to accrue from providing the management of the charity with strong incentives to implement cost-saving efficiencies.*[73] The agency theory suggests that patrons calculate these competing costs and rationally choose the non-distribution constraint in at least some situations in which the costs of monitoring quality are high.

2. Contract Failure and Agency Costs

Hansmann's basic insight is that there are situations in which the costs associated with acquiring goods in a normal market—the costs of monitoring and enforcing a quality product—are so great that the market will not produce the desired services, even if they are in great demand.[74] Malani and Posner call Hansmann's theory the "agency theory" because these monitoring and enforcement costs are plausi-

ty will not be sacrificed for private monetary gain." Susan Rose-Ackerman, *Introduction, in* THE ECONOMICS OF NONPROFIT INSTITUTIONS: STUDIES IN STRUCTURE & POLICY, *supra* note 16, at 3, 5.

[70] For acknowledgement of the loss of efficiency-enhancing incentives, see Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. REV. 501, 518–19 (1990) ("Hansmann's theory . . . assumes arguendo that nonprofit management will overcome the temptations of waste, or worse, at least to the extent that losses from waste attributable to lack of scrutiny by equity owners do not exceed gains from the reduced incentives to increase distributable income by skimming.").

[71] Hansmann, *Reforming*, *supra* note 16, at 507.

[72] *Id.*

[73] This "formula" does nothing more than summarize Hansmann's theory that the nonprofit form is the most efficient form when contract failure makes transaction or agency costs excessively high.

[74] *See* Hansmann, *Role*, *supra* note 16, at 845 (defining "contract failure").

bly called "agency costs."[75] The literature on agency costs generally proposes that whenever one person engages another to perform services on his behalf the parties will incur some "positive monitoring and bonding costs (nonpecuniary as well as pecuniary), and in addition there will be some divergence between the agent's decisions and those decisions which would maximize the welfare of the principal."[76]

Generally, it is understood that no compensation structure could perfectly align the interests of the agent and principal and so some agency costs will always be incurred in an agency relationship.[77] But what makes one compensation arrangement more efficient than another in any specific situation is how it reduces agency costs specific to that situation.

Nonprofit organizations have been intriguing to "agency-cost" thinkers because they pose a notoriously intractable "agency cost" problem. While "owners" are presumed to make efficient decisions about how much to expend to monitor their agents in for-profit firms, nonprofit firms have no owners, and therefore, there is no one

[75] It would actually be more accurate to call them "transaction costs" since the costs described are those associated with ensuring that a quality product is provided in what may well be a one-off transaction in the marketplace. *See supra* note 18. "Agency costs" are more accurately associated with the costs incurred *within a firm* when the owners of the residual value in the firm (the principals) employee non-owner workers (the agents) to diligently increase that residual value. *See, e.g.*, Louis Putterman, *Ownership and the Nature of the Firm*, 17 J. COMP. ECON. 243, 244 (1993) ("The . . . separation of ownership and work is the basic cause of the familiar agency problem between employer and employee."). Hansmann does not use either term. In this Article, I have chosen to use the term "agency costs" because it is used to describe the costs involved (monitoring, etc.) consistently in the literature. *See, e.g.*, Robert H. Sitkoff, *An Agency Cost Theory of Trust Law*, 89 CORNELL L. REV. 621, 635 (2004) ("The agency cost theories of the firm focus on the problems of shirking and monitoring that stem from information asymmetries within the organization's component relationships."). The type of market transaction engaged in between a donor and an entrepreneur in Malani and Posner's article could plausibly meet the definition of an "agency relationship," giving rise to agency costs, at least under a definition provided by Michael Jensen and William Meckling in a seminal article on the subject: "We define agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent." Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

[76] Jensen & Meckling, *supra* note 75, at 308. According to Jensen and Meckling, "monitoring" costs are those incurred by the principal to ensure that his interests are maximized, and "bonding" costs are those incurred by the agent to assure the principal that the agent is maximizing the principal's interests. *See id.* at 308–09. Agency costs also include the residual loss incurred by the divergence of interests that is not corrected by expenditures for monitoring or bonding. *Id.*

[77] Sitkoff, *supra* note 75, at 637.

who can gain financially from ensuring that agents act efficiently.[78] From a legal point of view, a board of directors is ultimately responsible for the actions of the organization, but this board of directors itself has no right to residual value in the firm, and no one with such an interest can discipline the board for failing to maximize benefits.[79] Nor can the board be disciplined by a market for corporate control since the right to elect board members is either held by the board itself or by "members" whose control rights cannot be sold. This lack of strong incentives among private parties coupled with restrictive standing rules is perceived as a perfect storm that creates outrageous inefficiency in nonprofit firms.[80]

While there are no true "principals" in the nonprofit organization from a legal point of view, the non-distribution constraint creates a sort of theoretical agency relationship between the managers (as agents) and the mission of the nonprofit.[81] Because any residual value in the firm is committed to the *mission* of the organization, the managers are in effect working for the ultimate benefit of the mission since they have fiduciary duties to faithfully pursue the mission.

But, of course, the "mission" of the charity is often somewhat diffuse and undefined, and there is no existing *person* who can enforce the management's fidelity to its best interest—at least no one with a financial interest in doing so. Even the charitable beneficiaries, who may sometimes benefit financially from the charity, are too diffuse a

[78] *See, e.g.*, Putterman, *supra* note 75, at 256 ("[W]hereas the existence of a residual claimant and holder of alienation rights is regarded as the best guarantor of efficient resource use where conventional goods are concerned, it is the absence of such [a person] that is called for [in the nonprofit setting].").

[79] The board can be held legally accountable but not by anyone with a right to the residual value in the firm. For example, the state attorney general is authorized to sue in all states. *See* RESTATEMENT (SECOND) OF TRUSTS § 391 cmt. a (1959) ("[A] suit to enforce a charitable trust can be maintained by the Attorney General of the State in which the charitable trust is to be administered.") In some states, donors may sue under certain circumstances, as can others with "special interests" in the organization. *See* Jonathan Klick & Robert Sitkoff, *Agency Costs, Charitable Trusts, and Corporate Control: Evidence from the Hershey's Kiss-Off*, 108 COLUM. L. REV. 749, 818–19 (2008) ("Almost half the states have given Donors standing concurrent with the attorney general to enforce a charitable trust.").

[80] *See, e.g.*, Klick & Sitkoff, *supra* note 79, at 782 ("The prevailing scholarly view, in other words, is that agency costs are rampant in charitable trust governance.") (citing Richard Posner, Marion Fremont-Smith, Henry Hansmann, Harvey Dale, Evelyn Brody, Alex Johnson, Dana Brakman Reiser, Ronald Chester, and Susan Gary).

[81] *Id.* at 780 ("[A] charitable trust must be for the benefit of a charitable purpose . . . not for a specific beneficiary. . . . Hence, for a charitable trust there is no identifiable beneficiary with an economic incentive and legal standing to ensure [that the charity efficiently pursue its purpose.]").

class to adequately enforce the obligations of the charity's management, even if they were legally permitted to do so.

If the beneficiaries cannot fulfill a monitoring role, then the donors could potentially play the role of "principals" in the agency relationship. To the degree to which they have donated money to the organization for the purpose of advancing the organization's charitable mission, it is in their interest to make sure that money is spent well. The problem is that it is not always entirely clear that the donors' *sole* interest is in advancing the organization's charitable mission. Any divergence of the donors' interests from those of the charitable mission of the organization means that the donor will not be a perfect guardian of the *true* principal's interest.

Even though the donor is not really the true "principal" in the nonprofit charitable form, in Hansmann's theory it is the donor who must make a decision about how to provide charitable goods, and so it is the donor who must perform some sort of "agency cost" analysis to determine whether he would be better served trying to provide those charitable goods through a nonprofit or a for-profit firm.[82] Hansmann's theory posits that when donative charities provide charitable goods, it is likely that the "agency costs" involved in monitoring quality, in bonding, and in losses involved in inadequately monitoring or bonding *in a for-profit firm* are likely to persuade donors to make their donations to nonprofit providers.

3. Donors and the Market for "Altruism"

The insight described above—that donors are not the true "principals" in a charitable transaction and yet are the ones who choose which organizations get support—is extremely important. The idea that socially beneficial goods can be provided through private charities depends on donors having at least some interest in socially beneficial outcomes. If the government seeks to subsidize the provision of socially beneficial outcomes—charity—then it must be able to determine when and to what extent it can rely on the choices

[82] While I treat the donor as the sole "principal" in Part II of this Article, the central thesis described in Part III is that the donor is *not* the only principal. When the government provides tax incentives to donors to make charitable contributions, *it too becomes a principal.* The government then must examine its own agency costs. The American system of subsidizing charities through a generally applicable subsidy for charitable donations gains much of its strength from the incorporation of this central agency-cost insight: the government can save agency costs in providing charitable goods if it can identify donors whose interests broadly align with its own. Thus, identifying those donors is the central concern of the law governing the charitable tax deduction.

of donors. That is, the government needs to be able to determine when donors' interest is in providing charitable goods and when they have other interests that the government may not share. If that is true, then some explanation is needed of what donors are doing when they donate money to charities.[83]

Hansmann called the people who provided the money to fund nonprofit organizations, the "patrons."[84] Patrons are both regular customers who purchase a good, like medical care, for their own consumption, and "donors," who purchase a good for the benefit of some unknown third party.[85] But since this Article focuses on donative nonprofits, only donors are of interest. Donors are in some ways like customers who trade their money for something they want. All other things being equal, they try to get services of a certain quality at the cheapest price they can. In other words, they try to maximize their own utility in the transaction.

The donor who provides charitable goods to benefit a third party is both similar and different. Hansmann's example of a provider of third-party services is CARE, an organization that provides relief food or medical care for poor people in developing countries, especially Africa.[86] When a person contributes money to CARE, he is doing so *for the purpose of* helping someone else.[87] He wants to help that person. He wants to do good for someone other than himself. In this Article, I will call this act "altruistic."[88]

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[83] *See, e.g.*, Henderson and Malani, *supra* note 8, at 577–78.

[84] *See* Hansmann, *Reforming*, *supra* note 16, at 502–03. One could imagine other potential types of suppliers of money to an organization. For example, organizations often receive money from people who are not "patrons" in either the donative or the commercial sense. This money is not payment for services; rather it is capital to be used to build up or expand the business, with the assumption that earnings (from payments from patrons) will follow in sufficient amounts to justify the expenditure of the capital. These providers of money should probably be called "investors." A sustained treatment of investors is beyond the scope of this work.

[85] *Id.* There is also arguably a subclass of donors who purchase so-called "public" goods both for their own consumption and for the consumption of the general public. For example, a donor to listener-supported radio contributes in order to enjoy programming that he likes but also to permit others to enjoy the same programming. He either values the fact that others are "free-riding" on his donation or he is indifferent to it.

[86] *Id.* at 505.

[87] *Id.*

[88] Of course, *pure* altruism may not be the only reason why a person donates to a donative charity. He may receive some sort of immaterial gain from the transaction. For example, he may gain the trust or respect of his peers by donating. This trust or respect may be a good in itself, or it may be useful to the donor in the future in some transaction with his peers that may result in material gain to him. Even if he donates anonymously, it is possible to describe the donor's motivation as a form of benefit to

While it is slightly awkward to do so, I will use the word "altruism" as a good or service sought by donors to a charitable endeavor.[89] Thus, when a donor contributes money to a charitable enterprise with no expectation that he will get it back, and no expectation that he will receive anything of material value in return for it, I will say that he has purchased some altruism. Thus, in Hansmann's example of the African relief organization CARE, the money provided by donors can be explained only if we assume that these donors want to advance the health of African children—that is, they want some altruism—and they are willing to pay for it. So, donors are similar to "customers" (the other subcategory of patrons) in that they are purchasing something (in this case "altruism") for themselves. But it is important to distinguish them from other customers because the nature of the good they are buying—altruism—is different from the nature of what is being bought by other customers.[90]

The reason I care about distinguishing "altruistic" motives from non-altruistic motives is not because I argue that altruism itself deserves to be rewarded with government largess. Rather, the point is that when a donor provides altruism to himself, he provides something that benefits the general public. Therefore, the government's ability to identify the donor seeking altruism may be the key to the government's ability to provide tax benefits in an efficient manner. Tax benefits to donors seeking altruism advance the government's in-

himself. He donates because it makes him feel good to do so. This motivation has been called "warm glow." *See* Galle, *supra* note 15, at 1222; *see also* Henderson & Malani, *supra* note 8, at 583 (identifying "warm glow" motivations, distinguishing them from "pure altruism," and stating that they use the term "altruism" to describe a mixture of warm glow and pure altruism). These possible immaterial benefits, therefore, range on a spectrum from those benefits that are closest to a financial benefit to those motives that are practically indistinguishable from the genuine desire to assist others. For example, it is hard to discern a precise difference between donating to the entrepreneur's efforts to help African children because it makes the donor feel good and donating out of a genuinely non-self-interested desire to help. Luckily, for the purposes of this discussion, it is not necessary to distinguish between genuine other-directedness and a desire to help someone because it makes one feel good; it is enough to call both of those things "altruism." Accepting that "altruism" is a tricky and controversial concept, I am satisfied with the definition of "weak altruism" provided by Rob Atkinson: "The point to be made here is that, despite unclarity at the margin, the central concept of weak altruism—a transfer without a quid pro quo—is not only intelligible, but also operable, as a criterion for drawing distinctions with important legal consequences." Atkinson, *supra* note 70, at 531–32.

[89] In this usage, I follow Henderson & Malani, *supra* note 8, at 573 ("With total charitable activity . . . totaling nearly one trillion dollars in the United States last year, the demand for altruism is obvious.").

[90] As Rob Atkinson has pointed out, this situation is unusual, and it is worth emphasizing "the distinctiveness of transactions in which one party confers a benefit on another without the expectation of material reward." Atkinson, *supra* note 70, at 523.

terest in providing public and third-party goods. Tax benefits to donors seeking non-altruistic goods do not advance the government's interests.

B. *Malani and Posner's Application of the Agency Theory*

Malani and Posner argue that the charitable deduction should be provided to donors to *any* firm that provides charitable goods, whether the firm is a nonprofit or a for-profit.[91] The agency theory provides an explanation for why purchasers of altruism would, in most cases, prefer to purchase their altruism from nonprofit firms.

Malani and Posner begin their article with a hypothetical, which they use to illustrate why a donor and an entrepreneur might choose to structure their donative transaction in a *for-profit* form.[92] When examined more closely, however, their hypothetical actually illustrates quite well why—consistent with Hansmann's prediction—a donor would almost always choose a *nonprofit* rather than a for-profit structure for his charitable contribution. The donor would choose a nonprofit to provide altruistic goods because the cost of monitoring the "product quality" of altruistic goods will almost always exceed the gains that he may predict could be caused by the incentives provided by the for-profit form. Malani and Posner's hypothetical illustrates this cost-benefit analysis because they craft a sort of private non-distribution constraint to cabin the costs of monitoring product quality, thus illustrating the necessity of a non-distribution constraint to ensure product quality in most donative charities. The best way to evaluate this argument is by investigating Malani and Posner's hypothetical in some detail.

1. The Non-Distribution Constraint's Effect on the Entrepreneur's Compensation

Malani and Posner ask us to imagine that an entrepreneur "wants to establish a charity to improve the health of children in developing countries."[93] She will do so by devising ways to provide clean water to previously underserved remote villages in Africa.[94] Thus, Malani and Posner's hypothetical is a classic donative-type char-

[91] Malani & Posner, *supra* note 8, at 2022.
[92] *Id.* at 2018.
[93] *Id.*
[94] *Id.*

ity and is very similar to Hansmann's example of a donative organization, CARE, which provides food to hungry children.[95]

The donor in Malani and Posner's hypothetical generally conforms to the image of a donor discussed above.[96] It is unclear exactly why the donor does what he does, but it is certain that he wants to provide money and in return obtain some benefit for African children. He wants to purchase some altruism.[97] But Malani and Posner are actually more interested in the entrepreneur than the donor in the transaction.

In Malani and Posner's hypothetical, the entrepreneur thinks that her activities potentially create altruism.[98] She does not want to provide her own money in exchange for that altruism, though.[99] She thinks that other people may want to help African children and that they may be willing to provide cash in exchange for it.[100] She wants to provide her labor (her organizational, managerial, or innovative skills) to improve children's health, and she wants to receive at least some money in exchange for it.[101] Thus, she makes a deal with the donors: if they give her some cash, she will improve the health of Af-

[95] *Compare* Malani & Posner, *supra* note 8, at 2018, *with* Hansmann, *Reforming*, *supra* note 16, at 505.

[96] *See supra* Part II.A.3.

[97] Among other things, we know that the donor is not an "investor," as that term is described *supra* note 82. The non-distribution constraint prevents the donor from receiving any financial return on his contribution. I will assume for the present that the donor is not the same person as the entrepreneur, even though there is nothing in current law to prevent the donor from being paid for his labor by the charity, nor is there anything to prevent the entrepreneur from donating to her own charity.

[98] Malani & Posner, *supra* note 8, at 2032.

[99] *Id.* at 2018 ("Running this charity will require the entrepreneur's time and effort, for which she would like to be compensated out of the funds that the organizations obtains from donations or revenues from any sales made in developed countries.")

[100] *Id.*

[101] *Id.* at 2018–19. The question of whether the entrepreneur is also seeking some "altruism" for herself is one that is central to many treatments of this issue. In other words, it is possible that the entrepreneur will seek *less* financial compensation for providing children's health because she values doing it for its own sake. To the degree to which donors can perceive the fact that the entrepreneur wants to advance the same altruistic goals as they do, donors would be very wise to invest their money with the entrepreneur, since their unanimity of interests has the potential to completely eliminate agency costs, which, after all, arise from the disparate interests of agents and principals. Some commentators have emphasized the entrepreneurs' acceptance of *low* salaries as a signal of their altruism. *See, e.g.*, Galle, *supra* note 15, at 1225; Daniel Shaviro, *Assessing the 'Contract Failure' Explanation for Non-Profit Organizations and Their Tax-Exempt Status*, 41 N.Y.L. SCH. L. REV. 1001, 1003 (1997). The problem, of course, is that acceptance of low salary may be a sign not only of the "altruism" of the entrepreneur but also of her incompetence.

rican children.[102] This is a simple transaction between a provider of labor (the entrepreneur) and some providers of funds (the donors). This Article assumes that the entrepreneur wants to maximize her financial compensation—she is not seeking any altruism for herself.[103]

Malani and Posner argue that the entrepreneur has the choice between two basic forms of compensation for her efforts on behalf of the African children. On the one hand, she can provide herself with a "fixed" salary, in which case she can create a "nonprofit" firm and employ herself as its director.[104] If she would prefer, however, she can pay herself with whatever funds are left over after she provides health to the African children—the "profits" of the firm—in which case she can structure her charity as a "for-profit."[105] Malani and Posner ask: Why should the existence of an income-tax deduction for contributions to nonprofit firms, but not for-profit firms, influence this simple arrangement between donors and the entrepreneur? Since economic theory suggests that the for-profit model is preferable to many consumers in the provision of goods for themselves, why should we assume ex ante that donors would not prefer to use a for-profit structure in providing health to African children?[106]

Malani and Posner briefly recount the well-accepted reasoning that supports consumers' choice of for-profit firms for regular consumer goods. In order to explain the choices of compensation structure available to the donors and the entrepreneur, they ask us to imagine a transaction in which the donors want to provide for the health of African children by supplying them with fresh water.[107]

[102] Malani & Posner, *supra* note 8, at 2018.

[103] Malani and Posner argue that "[o]ne problem with the agency theory is that it assumes that only altruistic Entrepreneurs will choose the nonprofit form, and that nonaltruistic entrepreneurs will always choose the for-profit form." *Id.* at 2034. As discussed herein, the agency theory suggests that *non*-altruistic entrepreneurs will choose the nonprofit form when the agency costs of ensuring a quality product exceeds the (predicted) loss of efficiency from removing profit as an incentive for creating efficiency. None of the works cited by Posner and Malani support their claim that the "agency theory" only explains the choice of the nonprofit form when the entrepreneur is altruistic. *See, e.g.*, Glaeser & Shleifer, *supra* note 16, at 102 () ("Our basic results . . . do not depend on Entrepreneurial altruism . . . . [But] our model shows that more altruistic Entrepreneurs would opt for nonprofit status.").

[104] Malani & Posner, *supra* note 8, at 2018.

[105] As discussed *infra* Part IV, this simple binary description of possible compensation structures does not conform to reality. Instead, it makes more sense to envision an array of possible compensation structures, with "fixed" at one pole, "profits-based" at the other, and various types of "incentive-based" structures inhabiting the range of possibilities between the poles.

[106] *See* Malani & Posner, *supra* note 8, at 2019.

[107] *Id.* at 2018.

Through the efforts of the entrepreneur, "the charity raises $10 million from donors but manages to develop a water filtration system at a cost of only $8 million."[108] Now imagine the two possible compensation structures described by Malani and Posner. If the charity is a for-profit, the entrepreneur can take home the two-million-dollar profit. That is her compensation. If the charity is a nonprofit, then the entrepreneur would only be paid the fixed salary to which she agreed in advance.[109]

There is a compelling reason why donors might want to compensate the entrepreneur using a "profits" interest in the firm. Donors know that the entrepreneur is the one most likely to discover cost-saving mechanisms for providing water to African children.[110] After all, the entrepreneur is the one who is there. She is the one who presumably knows the most about African children, their needs, and how best to provide for those needs. If the entrepreneur acts to maximize her financial interests, then providing her with a financial incentive to reduce the costs involved in providing water to African children is the best way to maximize the chances that such cost-saving efficiencies will be discovered or implemented.[111] Thus, there may be good reasons to incentivize the entrepreneur's discovery and imple-

[108] *Id.* Malani and Posner use ten million dollars and eight million dollars when they initially introduce their hypothetical, but they later change the amounts to one hundred dollars and eighty dollars. *Id.* at 2027.

[109] Malani and Posner suggest that the for-profit structure may be better than the nonprofit because, if the entrepreneur is very talented, she could make a lot of money at a for-profit company and she may not be willing to work at the nonprofit for such a low salary. Malani & Posner, *supra* note 8, at 2019. They also suggest that she might need to provide a "profits" interest in the firm not just to herself, but "to motivate her employees to work hard." *Id.* If high quality entrepreneurs prefer the for-profit form, then donors might prefer it as well in order to retain talented managers or workers. Malani and Posner's assumption, however, that a nonprofit wage (a "fixed" salary) is necessarily a *low* salary is not reflected either conceptually or actually in the law of nonprofits. There is nothing about the non-distribution constraint, or in the law of charitable nonprofits, that prevents nonprofit firms from paying an executive what her labor is worth. This subject is discussed more fully *infra* Part IV. At least theoretically, if the entrepreneur could be paid a fixed salary of two million dollars at a for-profit firm doing similar work, she could be paid two million dollars to manage the nonprofit firm. "Thus, nonprofit law does not compel the argument that the entrepreneur will abandon nonprofit firms because the pay is too low.

[110] Malani & Posner, *supra* note 8, at 2027.

[111] As Evelyn Brody has pointed out, "[W]hile the nondistribution constraint might convince the patron that the nonprofit is more trustworthy than a for-profit in situations of opportunistic behavior, the nonprofit could be even less trustworthy in avoiding inefficient expenditures." Brody, *supra* note 8, at 464. Atkinson describes this problem with a reference to equity owners: "Without equity owners looking over their accounts, if not their shoulders, nonprofit managers lose an important incentive to minimize costs." Atkinson, *supra* note 70, at 518.

mentation of cost-saving methods of providing water.[112] The proper question is not how high or low the entrepreneur's compensation is but who bears the *risk* that the costs of providing the service promised will be greater than or less than those expected by the donor.[113] It is obvious why donors may want the entrepreneur to bear that risk (and be compensated with the upside potential of being able to provide the agreed-upon goods at a lower-than-expected cost).[114]

But the impediments to the donor compensating the entrepreneur with a profit interest in the transaction are substantial. The primary impediment to the for-profit structure is the predicted cost the donor will incur in monitoring the *quality* of the altruistic goods provided by the entrepreneur. Remember, with ordinary consumer goods, like a cup of coffee, the purchaser of the good can evaluate the quality immediately, simply by taking a sip. He can choose to never again buy coffee from a provider who has not supplied sufficient quality to justify the price. But in the case of altruistic goods, the donor does not have immediate access to the information necessary to evaluate the quality of the good supplied. The goal is to provide water to African children. How much water has been provided? What are comparable costs of providing water from other suppliers? Has the water been provided in a sustainable way? Is providing water even the best way to improve the lives of children? Is one's contribu-

[112] Donors are unlikely to agree that the entrepreneur can take home *all* of the savings she provides, but one could imagine an agreement by which they split the profits in some way. That is, she provides them with a slightly lower cost product and keeps the remainder as compensation for producing the savings that resulted in the lower cost to the donors.

[113] If the entrepreneur were restricted to a fixed salary, as Malani and Posner argue she is in a nonprofit firm, then she would have to decide ex ante what the split would be between her salary and the administrative costs. If she could compensate herself with a "profits" interest, as she can in a for-profit firm, then she could wait and pay herself whatever is left over after she pays all the administrative costs. Thus, the difference between a "fixed" salary and a "for-profit" salary is actually one of *time* (and therefore it is an allocation of risk). If the entrepreneur chooses a "split" of administrative costs ex ante, then her compensation is "fixed," and the donor bears the risk that other administrative costs will be high; if she waits until actual, other administrative costs are incurred to determine how much of the total administrative cost pie she can keep for herself, then she has a "profits" interest and she bears the risk that other administrative costs will be high. Economic literature on "incomplete contracts" suggests that when it is impossible for a contract to fully specify potential outcomes, the allocation of residual control rights is extremely important because it determines who benefits from an innovation or a changed outcome. *See, e.g.*, Oliver Hart, *Incomplete Contracts and Public Ownership: Remarks, and an Application to Public-Private Partnerships*, 113 ECON. J. C69 (2003).

[114] Posner and Malani do not expressly consider the possibility that the entrepreneur could get paid nothing under the for-profit model, although, theoretically, this should be a possibility.

tion providing any marginal benefit, or would the benefit be the same without that contribution?[115] Answering all of these questions has some cost, and the uncertainty that arises from being unable to answer these questions can also be described as a cost. These costs are the "agency costs" that give the so-called agency theory its name.

Thus, in the case of altruistic goods, like the one described in Malani and Posner's hypothetical, the "agency costs" associated with assessing and monitoring product quality are substantial. When agency costs are high, donors may prefer a nonprofit form. Another way of looking at the issue is that the "agency costs" described are all related to assessing whether the entrepreneur is providing a quality good, or is, instead, enriching herself by shirking on quality.[116] If it is too expensive for the donor to ensure himself that the entrepreneur is not enriching herself by providing low-quality services, then a nondistribution constraint is a rational choice.[117]

[115] The situation can be illustrated as follows: First, imagine a donor paying $100 to an organization that provides $100 worth of food to African children. Obviously, the donor would be happy with that outcome; there was no payment necessary for the administrative costs of getting the food to the children. Second, imagine that a donor pays $100 to an organization, that other donors pay $10,000 to the same organization, and that the organization provides $10,100 worth of food to African children. Again, the donor got a great deal since all of the money spent provided a benefit to her intended beneficiaries. Finally, imagine that a donor pays $100 to an organization to which other donors pay $10,000 but that the organization only provides $100 worth of food to African children (presumably, the $10,000 goes into the pockets of the managers of the organization). The donor still got $100 worth of food for African children for her $100 donation, but the managers pocketed the money provided by everyone else. If this final hypothetical organization does not provide a "quality good" in exchange for the donations received—if a donor would prefer to give her money to the first or second organization—then "altruism" is a good such that its *marginal benefit* is a material consideration for donors. In order to separate the benefit attributable to the donor's payments from the benefits attributable to everyone else's donations, it is important whether one donor's payments can be identified with some measurable output of benefit'.

[116] The counterpoint of the agency costs involved in assessing product quality suggests an alternative formulation of the "formula" proposed above. *See supra* Part II.A.1. The assessment of "agency costs" could be expressed in this way: *the nonprofit form will be chosen whenever it is impossible or prohibitively costly for the Patron to distinguish profits derived from efficiently providing a high-quality product and profits derived from shirking on quality.*

[117] As Malani and Posner put it: "The nondistribution constraint blunts the incentive of the Entrepreneur to shirk by limiting the return that the Entrepreneur receives from the operation of the firm." Malani and Posner, *supra* note 8, at 2033–34.

2. Malani and Posner's Hypothetical Reduces Agency Costs by Replicating the Non-Distribution Constraint

Malani and Posner solve the "agency cost" problem *not* by showing how the cost of monitoring product quality could be reduced, but by creating a hypothetical situation in which the entrepreneur cannot enrich herself by shirking on quality.[118] In other words, they create a private non-distribution constraint, which solves the agency cost problem in the exact same way the non-distribution constraint is intended to solve the agency cost problem: by committing a certain amount of money to be spent on charitable purposes and preventing the entrepreneur from enriching herself by reducing that amount of money. Malani and Posner illustrate the difference between compensation in a for-profit firm and a nonprofit firm as follows: they ask us to imagine that the entrepreneur promises the donors that she will use eighty percent of their donations directly to provide for sick children in Africa.[119] They define a "high quality product" as providing eighty percent of every dollar donated to the children.[120] Presumably, that reflects the donor's best information about what he could obtain from other providers in the relevant market. One should note that with respect to the eighty percent provided to children in Africa, the entrepreneur is not permitted to increase her compensation by providing services more efficiently. She must use all eighty percent of the money provided for the benefit of the children, no matter how much it costs to provide them with water. In other words, she is bound by the non-distribution constraint!

Thus, without saying so explicitly, Malani and Posner concede that with respect to the eighty percent provided to the African children, *the nonprofit model is preferred.* Presumably, this non-distribution constraint is necessitated by the very agency costs that make the non-distribution constraint so often the most efficient method of providing charitable goods—the cost of identifying what would constitute a benefit for the African children and monitoring whether an agreed-upon benefit has been provided for each dollar donated. But Malani and Posner do not seem to appreciate that the non-distribution constraint in this part of their organization will have the very same costs as elsewhere—the entrepreneur has no incentive to provide actual

[118] *Id.* at 2027.

[119] Malani and Posner state that the entrepreneur will "ensure [that eighty percent of the money they donate] reache[d] the hands of the sick children[.]" *Id.* They also state that she will "send [eighty percent] of the donation to sick children." *Id.*

[120] *Id.* at 2032.

benefit to the African children efficiently; as long as she spends eighty percent of the money on *something* in Africa, she has provided a quality good.[121]

Malani and Posner then ask us to imagine that the remaining twenty percent has to be split between her personal compensation and "administrative costs."[122] These "administrative costs" must be separated from program costs, and the hypothetical only works if they can be reduced without harming the donor's interests. Malani and Posner suggest that the twenty percent of each donation that can be used for something other than the direct benefit of the children will be split between administrative costs and the entrepreneur's compensation.[123] They argue that the entrepreneur is more likely to find ways to reduce administrative costs if she is permitted to increase her compensation.[124] But the reason that this compensation structure appears to be so attractive depends on the nature of "administrative" costs. If these costs can be reduced without any reduction in the *quality* of the goods provided, then there is no reason for the donor to be concerned with whether they are paid to third parties or kept by the entrepreneur. Malani and Posner purport to define a quality product (eighty percent of each contribution goes to Africa) in a way that *reducing administrative costs cannot affect it.*[125] If there is no way for the

[121] Malani and Posner appear to recognize that contract failure may require some form of non-distribution constraint to facilitate an efficient transaction, and thus they propose several methods for using an express non-distribution constraint in what is otherwise a formally for-profit firm. *Id.* at 2036. They propose that if the entrepreneur promised to hire a manager to control all expenditures of the firm and did not allow that manager to profit from cost-saving innovations, the donors may be assured that the firm would not enrich itself by shirking on quality. *Id.* It is hard to see why this solution is better than a traditional nonprofit, because the manager who controls expenditures has no strong financial incentive to improve the efficiency of the firm. Second, Malani and Posner propose that "an auditor" could police the contract, which of course is one way to address monitoring problems, although it has a cost. *Id.* Finally, they suggest that the entrepreneur could institute a "cost-plus pricing scheme" in which the donors rather than the entrepreneur are the residual beneficiaries so the entrepreneur is paid a fixed salary, but the donors receive a refund at the end of the year if any cost-saving mechanisms are found. *Id.* at 2036–37. Again, it is not clear why this form is better than a nonprofit since the entrepreneur is still paid a fixed salary.

[122] *Id.* at 2027.

[123] Malani & Posner, *supra* note 8, at 2027.

[124] *Id.* at 2027–28.

[125] *Id.* at 2032. In point of fact, it is plausible that administrative costs are relevant to whether a quality product is provided, if they include the agency costs involved in ensuring the quality of the product. For example, imagine that some of the twenty percent spent on administrative costs help the donor monitor whether eighty percent of each dollar donated is spent in Africa or not. In that case, a donor would not

entrepreneur to reduce quality by decreasing administrative costs (i.e., all eighty percent is provided to African children), then there is no reason why the donor should object to the entrepreneur keeping any savings she creates through cutting administrative costs. In other words, Malani and Posner have created a hypothetical in which agency costs incurred in monitoring product quality with respect to administrative costs are *zero*. It is no wonder, then, that a for-profit compensation structure would be preferable in this situation.[126]

Thus, in Malani and Posner's hypothetical, the non-distribution constraint is necessary with respect to eighty percent of each donation, but a for-profit structure is more efficient for the other twenty percent.[127] The ideal solution would be for the law to permit this split. As discussed in Part IV, it does.

3. What if "High Quality Product" Was Defined in a Way that Did Not Replicate the Non-Distribution Constraint?

While Malani and Posner's choice of a percentage of money "going to" the charitable purpose replicates the non-distribution constraint, one could imagine an agreement between entrepreneur and donor in which "high quality" is defined not by an amount of *money* but by a quantum of *benefit*. This definition of "high quality" product could also create a situation in which agency costs may be minimized and the non-distribution constraint may be unnecessary or may result in an inefficient transaction.

Of course, the "quantum" of benefit would have to increase with each additional dollar contributed. This is necessary to ensure that each dollar donated provides some *marginal* benefit to the children. Presumably, it matters to the donor whether his contribution increases the benefit provided, and so he has an interest in monitoring not

be indifferent to cuts in administrative costs, unless they did not impact his ability to monitor the quality of the product provided by the entrepreneur.

[126] *See supra* Part II.A.1 (describing the "formula").

[127] Even as described by Malani and Posner, the hypothetical may well be objectionable to donors because it is only a good bargain for the donor if administrative costs reasonably increase in proportion to the amount of money provided for program costs. This is possible, but it is more likely that some administrative costs are fixed. In other words, the first fixed amount of money is needed to get lights turned on in an office (and other related expenses) and no money can be provided to African children until basic fixed costs are paid for. Then, after fixed costs are covered, administrative costs presumably decline. If that is true, then an entrepreneur's gamble that she can decrease administrative costs is really a bet that she can raise more money than is predicted and thereby enrich herself because the marginal costs of administration decline.

just the *overall* benefit provided by the charity but the benefit provided by *his contributions*.[128] It would not be sufficient to say that money is being raised to provide clean water to one million African children; rather, the entrepreneur would have to promise to provide a certain quantum of water per dollar contributed.[129] Thus under the hypothetical provided, in which the donor wishes to provide clean water to African children, imagine that donors are seeking to provide clean water to ten million African children.[130] Providers of aid other than the entrepreneur are offering to build a water delivery system that would benefit ten million Africans for ten million dollars (of which $500,000 is fixed compensation for their CEO). The entrepreneur believes that she can do it for eight million dollars plus her compensation. If the entrepreneur could provide the same amount of water for a lower price, then the for-profit model might be preferred.[131]

This hypothetical potentially does a better job of solving the incentive problem associated with the non-distribution constraint than Malani and Posner's hypothetical. In this case, the entrepreneur is incentivized not only to cut administrative costs but also to find more efficient ways of providing the identified benefit, which is, after all, what donors want her to do. But agency costs associated with this type of approach are also potentially higher. Because a quality prod-

[128] This concern with the marginal benefit provided with each dollar contributed could be called the "non-divisibility" problem that is generally an aspect of public goods. *See* Hansmann, *Reforming*, *supra* note 16, at 506 (stating that public goods are likely to be provided only by nonprofits because "owing to the indivisible nature of the service involved, the consumer generally has no simple means of observing whether his or her contribution has increased the level of the service provided[, r]ather, the consumer must take the producer's word that the contribution will be used to purchase more of the good, rather than simply going into someone's pocket").

[129] Malani and Posner's hypothetical, to its credit, did not completely ignore the divisibility problem. Some commentators, like Dan Pallotta, argue that once enough money is raised to meet the charity's goals, the entrepreneur should be able to keep whatever else she raised. *See* DAN PALLOTTA, UNCHARITABLE: HOW RESTRAINTS ON NONPROFITS UNDERMINE THEIR POTENTIAL 15 (2008). In that case, if the agreement was structured as a for-profit, it would be perfectly permissible, intended even, for the entrepreneur to put in her pocket every dollar contributed after she has provided the agreed-upon water to the one million children.

[130] And, in fact, Malani and Posner's initial hypothetical described a situation in which the "outcome" that defined a high-quality product was the provision of a "water filtration system," not the expenditure of a certain percentage of funds raised. *See* Malani & Posner, *supra* note 8, at 2019.

[131] Remember, this would only be the case if the cost-savings would not be produced *but for* the strong incentive created by the entrepreneur's profit-sharing compensation. If she discovered and implemented those savings without strong financial incentives to do so, then donors would still prefer the nonprofit form.

uct is defined with respect to an actual quantified outcome, that outcome must be monitored and that may involve agency costs that are not apparent at first blush.

First, the hypothetical assumes that a competitor who has offered to provide water to ten million Africans for ten million dollars has been identified. That solves the first agency-cost issue, which is how the donor gets adequate pricing information about the reasonably predicted cost of providing water to ten million Africans. Without a sufficiently robust market for the provision of water—and a market that has identified the good provided with some comparable quantifiable outcome—there can be no adequate pricing information to enable the donor to identify a "good deal" with sufficient precision.

Presumably, the only place to get this kind of information is from the market of altruism providers. So, for example, the donor needs to have some knowledge of the price per child of clean water as provided by competitors in the market. In order to know how much "profit" the entrepreneur should be permitted to take, donors need to know what a good "price" is for the outcome they seek. In the hypothetical, they know that the "ordinary" cost is ten million dollars. But knowing the "ordinary" cost is dependent on identifying the outcome with some precision. It is only once an outcome is identified with precision that a market (in this case, the market for altruism) can provide information about the ordinary cost of such an outcome. In the regular market for consumer goods, we can only know how much we are willing to pay for a Honda Civic once we know the price of a Toyota Corolla. We do not care how much profit Toyota or Honda are making from our purchase of their cars because we know how much *comparatively* those cars are worth. When we are talking about the market for altruism, that type of pricing information is much harder to come by. The difficulty in obtaining that information is arguably an agency cost. Unless other providers of health quantified their services in a reasonably comparable manner, this information is likely to be unavailable to the retail-level donor.

Only after adequate pricing information is available do we reach the classic monitoring problem: the donor would need to verify that the high-quality product was indeed provided—that ten million children got water on account of the donor's contribution. The costs of monitoring also include the costs associated with entering into an adequately defined agreement in the first place and of enforcing that agreement if no high-quality product was provided.

Finally, the donor would need to address the so-called "non-divisibility" problem. He would need to be able to make sure both

that water was provided in exchange for *his* contribution (and not for others') and that the pricing information he obtained was relevant to his size of contribution and not just to overall costs. In order to do that, the donor would need relatively robust information about all the other sources of revenue available to the entrepreneur and what terms were provided to those alternative sources.

Under the hypothetical, the entrepreneur thinks she can provide the water for eight million dollars, plus her compensation, while the closest competitor can only provide it for ten million dollars, including compensation. In such an extreme case, perhaps all of the agency costs combined might not equal the huge savings the entrepreneur is offering and so the for-profit model may be preferred. But it is much more likely that the agency costs involved would exceed the savings made possible by financial incentives for the entrepreneur to cut costs. For example, the two million dollar savings that the entrepreneur thinks she can achieve were created, after all, by a *huge* informational asymmetry. The donors think that the water can be provided for ten million dollars, including reasonable salary for the manager. The entrepreneur thinks that it can be provided for much less than that. And remember, the donors are not using their own personal expertise to price the provision of water. They have a presumably relatively robust market of other entrepreneurs and existing aid organizations seeking their altruism dollars to compare to the entrepreneur's offer. In other words, the donors *and every other competing provider of altruism in the market* think that water can only be provided to the African children for ten million dollars. But the entrepreneur thinks that she knows better. If the entrepreneur is wrong and does not achieve her projected savings of two million dollars, then the agency costs incurred by the donors may well exceed the actual efficiency gains provided by the entrepreneur's genius. A choice of the for-profit firm is a gamble that the entrepreneur will be able to find such efficiency gains. And it is also a gamble that *financial incentives* will produce these efficiency gains when no other incentives could. If the cost of identifying, verifying, and enforcing compliance, and all the other agency costs identified is higher than the predicted efficiency gains, then a nonprofit firm would be preferred, even if the entrepreneur is completely self-interested.

The nonprofit form, on the other hand, potentially mitigates all of these concerns. Once the profit motive is taken away from the entrepreneur, then she still may provide a low-quality service, but at least she will not use the savings from providing a low-quality service to enrich herself. If her expertise can permit her to provide high-quality services—and save two million dollars in the process—then

she may be able to find some incentive to do so even if her salary in that year is not directly dependent on the profits earned by the firm. Once the strong incentive of profit is removed from the equation, the risk of uncertainty in monitoring product quality may decrease because the incentive to shirk has been significantly diminished.

4. Donors Want to Enlist Entrepreneurs' Help in Figuring Out How to Measure Benefit to Charitable Beneficiaries

In addition to all agency costs discussed above, the most important agency cost related to many providers of charitable services may be the cost of quantifying benefit when the actual benefit sought could be *misidentified*. Charities rarely define their activities in ways that can easily be quantified in dollar terms. For example, CARE (Hansmann's example), describes its activities as follows: "CARE tackles underlying causes of poverty so that people can become self-sufficient."[132] While there are charities that merely distribute food to the hungry or medicine to the sick, charities like CARE seek to provide infrastructure development, capacity-building, micro-credit, or other assistance that is designed, or at least described, as providing the possibility to "tackle[] underlying causes of poverty" rather than just alleviate suffering.[133] Any charity that attempts to define its purpose in functional terms will have trouble defining a sufficiently precise agreement with donors as to some identifiable quantum of benefit to be provided.

Furthermore, even if a sufficiently precise agreement could be reached, efficiency may be lost from the precision of the agreement itself. This type of agreement would be inherently inflexible (if it could be enforced). If, for example, the best way to provide clean water were to change from well-digging to rainwater harvesting or the best way to provide health were to change from the provision of water to the provision of immunizations, then amending the agreement may be expensive. This inflexibility is an agency cost.

In fact, one of the things a donor is often seeking in the expertise of the entrepreneur is advice about the best method to eradicate poverty, for example. He does not just want the entrepreneur to be skilled at reducing administering funds so that a substantial portion "goes" to the ultimate recipient. Nor does he want the entrepreneur merely to provide a quantity of water cheaply. Rather, he wants the

[132] *What We Do*, CARE, http://www.care.org/careswork/whatwedo/index.asp (last visited Apr. 25, 2012).
[133] *Id.*

entrepreneur to devise some means to leverage his donation and actually reduce poverty. He wants substantive expertise. Quantifying the benefit to the poor children in terms of dollars that "go" to them does a poor job of measuring benefit. Even quantifying the benefit as a certain number of children receiving clean water does a poor job of measuring benefit. Good charities use the money they collect in innovative ways that—at least donors hope—will have a bigger benefit than merely sending dollars to the beneficiaries or providing easily quantified goods to them. The cost of permitting the entrepreneur to innovate and of structuring the transaction to encourage that innovation without overly incentivizing shirking on quality is also arguably an agency cost.

In other words, one could imagine situations in which the definition of a high-quality output is even more difficult to identify or measure than in either of the hypotheticals. While it may be imaginable how one would count cost effectively that are dollars going directly to the beneficiaries, or count number of children benefitted, it is much harder to make such an evaluation when the donor wants to provide flexibility to enable the entrepreneur to use the money in the most beneficial way. If there are changing circumstances, it may be preferable to leave the entrepreneur some flexibility to react to changing circumstances. In the charitable context, the outcome is often very hard to quantify, and so agency costs are often prohibitively high. In these situations, the "non-divisibility" problem really comes to the fore. If a donor wants to get guidance from the entrepreneur about the best use of funds or if he wants to leave the entrepreneur the flexibility to change uses to address changing circumstances, imagining an agreement that specifies *which* benefits were derived from *which* dollars donated is even more daunting. It becomes very clear why a donor under these circumstances would want a general solution to all these problems, such as the one provided by the non-distribution constraint, even understanding that there might be substantial efficiency losses caused by the removal of financial incentives for the entrepreneur to institute cost-saving mechanisms.

C. Conclusion of Part II

The above analysis suggests that under the most common circumstances, it is extremely unlikely that donors will choose to meet their altruism needs in a transaction with a for-profit organization. The agency costs associated with identifying a measurable output that can solve the problems associated with the non-divisible tendencies of altruism, as well as the more traditionally recognized costs of moni-

toring and enforcing compliance with the agreement once it is formed, are likely to overwhelm any efficiency gains that could be obtained through providing the entrepreneur with a profits-based compensation structure.[134] But this observation still does not explain why the government should deny tax benefits to a donor who identifies a situation in which he believes that efficiency gains from a profits-based compensation structure would be greater than losses from increased transaction costs.[135] I have not yet explained why the government should deny a tax deduction to a donor *who wishes* to donate to a for-profit organization when that donor *thinks* such an organization can provide altruism to him in the most economically efficient manner.

The following two Parts of this Article seek to provide an explanation for why at least the tax benefit of deductible contributions should be reserved for donations to organizations bound by the non-distribution constraint. Part III seeks to explain why the government's own agency-cost analysis counsels in favor of providing tax benefits only to firms that accept a single standard version of the non-distribution constraint and to deny it to those firms that have no non-distribution constraint or insist on crafting their own non-distribution constraint through private contracts. Part IV seeks to explain that contrary to Malani and Posner's assumption, current nonprofit law actually permits incentive-based compensation to nonprofit employees in any situation in which some measurable metric of success can be identified (other than pure "net profits"). Thus, the problem identified by Malani and Posner is not nearly as significant as they suggest.

[134] Oliver Hart's work on public versus private ownership of public services supports the point made in this Article he argues that private ownership encourages cost-saving innovation but that it also encourages "quality-shading" innovation. Hart, *supra* note 113, at C71 "The choice between public and private ownership depends on which of these effects is more important." *Id.*

[135] As Hansmann notes,

> A more fundamental problem with such a theory, however, is that it is not obvious why a subsidy is needed to encourage nonprofits even where their development seems appropriate as a response to contract failure. Why can consumers not be trusted to select nonprofit rather than proprietary producers on their own in those situations in which nonprofits are to be expected to offer more reliable service?

Hansmann, *Rationale*, *supra* note 18, at 70.

III. ACCOUNTING FOR THE GOVERNMENT'S INTEREST: A MODEL WITH THREE ACTORS

But why should the government reserve tax benefits exclusively to nonprofit charities? In fact, it appears that donors and entrepreneurs should be able to figure out that the nonprofit form is the best structure for their donative charities without any "nudge" from the government. The agency theory can be used not only to understand the motivations of donors and entrepreneurs in a transaction for charitable goods, but also to understand the motivations of the government itself. At least one reason why contributions to nonprofit charitable organizations are tax deductible, while contributions to for-profit charities are not, is because the government's own agency-cost analysis counsels in favor of the non-distribution constraint whenever the government seeks to provide tax subsidies for charitable goods.

In order to evaluate the choices the government should rationally make in providing tax benefits to charities, I initially assume that the government wants to provide some sort of charitable goods. That is, the government has determined that there is a reason to provide certain charitable goods. Justifications for providing tax benefits to providers of charitable goods are legion.[136] One widely accepted economic justification for providing tax benefits to providers of public goods is that because of the free-riding problem, these goods will be undersupplied by regular market mechanisms. Because third-party goods arguably are "non-divisible" (which is a close correlate of the quality of "non-exclusivity"), they too will be undersupplied by regular market mechanisms. A government subsidy increases the likelihood that such services will be provided at socially optimal levels.[137] This justification for the government providing charitable goods is well accepted, but—as Malani and Posner point out—it does not provide a justification for the government to provide public goods through nonprofit firms as opposed to for-profit firms.[138] My goal is to assess whether the government is rational to restrict the provision of tax benefits to nonprofit organizations—those organizations bound by the non-distribution constraint.

[136] For an excellent overview of "measurement" and "subsidy" theories, see Miranda Perry Fleischer, *Theorizing the Charitable Tax Subsidies: The Role of Distributive Justice*, 87 WASH. U. L. REV. 505, 514–27 (2010). She argues that the justification is not complete until distributive justice concerns are more fully integrated. *Id.* at 528–53.

[137] *See, e.g.*, Gergen, *supra* note 47.

[138] Malani & Posner, *supra* note 8, at 2011.

Once it is assumed that the government wants to provide charitable goods, the government's methods for doing so can be assessed. This Article derived a "formula" for determining when a donor would choose the nonprofit form. The formulation was as follows: *the nonprofit form will be chosen whenever the cost of monitoring and enforcing a specific level of product quality exceeds the gains that are expected to accrue from providing the entrepreneur with strong incentives to implement cost-saving efficiencies.*[139] In other words, if the so-called agency costs are high enough to make the donor fear that permitting the entrepreneur to take a profit interest in the transaction would result in shirking on quality, the donor is rational to seek to impose a non-distribution constraint.

If it is correct that the donor would be prudent to engage in some sort of agency-cost analysis before making a donation to a charitable entity that compensated its entrepreneur with the "profits" from the firm, it also seems prudent for the government to engage in a similar type of agency-cost analysis before providing public goods. This seems like an obvious observation, but it appears to have been rarely appreciated.[140] If the justification for the government providing tax benefits is that it seeks to subsidize the provision of a certain type of goods, the government is not just a regulator of the market but a participant in the market for those goods. It seeks to provide resources to further the production or acquisition of those identified goods. As a market participant in the provision of charitable goods, the government presumably has the same agency-cost concerns as do private participants in the market for such goods. Just like donors to charitable organizations, the government needs to assess how it can

[139] *See supra* text accompanying note 73.

[140] Henry Hansmann recognized in passing that the government is, in effect, a market participant when it provides tax benefits to charitable organizations. *See* Hansmann, *Reforming*, *supra* note 16, at 605 ("To be sure, federal tax law does effectively make the government a patron of many nonprofits, and to this extent the government has an interest in policing the behavior of nonprofits that is much like that of any other patron. . . . For the limited group that both qualify for the charitable deduction and receive considerable donative support, the government is in effect a substantial contributor."); Henry Hansmann, *What is the Appropriate Structure for Nonprofit Corporations Law?* 22 (Yale Univ. Inst. for Soc. and Policy Studies Program on Nonprofit Orgs., Working Paper No. 100, 1985) ("[O]ne important reason that statutes providing subsidies and special preferences require that the recipient organizations be nonprofit is presumably that these statutes are providing donations of a sort to these organizations, and seek the fiduciary restraints of the nonprofit form for the same reasons of contract failure as do other Donors.") Subsequently, Atkinson has made this point. Atkinson, *supra* note 70, at 516 n.55 (citing Hansmann, *Role*, *supra* note 16, at 847); *see also* Estelle James, *The Nonprofit Sector in Comparative Perspective*, *in* THE NONPROFIT SECTOR 397, 408 (1987).

obtain charitable goods most efficiently, given that the people who actually provide them—the government's "agents" in the transaction—may be motivated by financial incentives.[141]

A. *The Government's Provision of Public Goods*

If public goods and third-party goods create problems for donors, they presumably create similar problems for the government. Namely, the cost of monitoring the quality of the output of providers of third-party goods may be prohibitively high for the government. Even more problematic may be the "non-divisibility" problem. That is, the government may also have difficulty making sure that a provider of a public good does not just "re-sell" the very same goods to other donors after the government has made its contribution.

Of course, the government has many tools to avoid these problems. First, it could review each transaction to determine whether there is a measurable output that can be identified with a high-quality product. If the government can identify such a measure of quality and it is relatively inexpensive to bind the entrepreneur to providing a high-quality product, then the government may consider permitting the entrepreneur to assume the financial risk and benefit from providing that product efficiently. That is, if the government can cost-effectively identify and enforce a high-quality product requirement, then it may choose to structure its transaction as a for-profit.[142] The government does this all the time when it provides public goods through contracts with for-profit firms, as Malani and Posner recognize.[143] But note that the government will not contract with a for-profit firm for the provision of public goods if it cannot identify a measurable output and bind the firm to the provision of high-quality goods in a relatively cost-effective way.[144] Hansmann's "contract fail-

[141] The implication of this observation is that charities are the "agents" not only of their donors, who assume the role of principal by virtue of their "altruistic" donations, but also of the government, which assumes the role of principal by virtue of its tax subsidies for "charitable" activities.

[142] Remember, if the government cannot identify a high-quality product so that it can bind the entrepreneur to providing that quality of product before calculating her profit, then structuring the transaction as a for-profit is inefficient. The Entrepreneur (assuming she is not altruistic) will simply shirk on quality in order to capture increased profits and will have a lessened incentive to provide the product efficiently.

[143] Malani & Posner, *supra* note 8, at 2051 ("[T]he government can purchase public goods through ordinary procedures for government procurement, which include competitive bidding.").

[144] The government's choice between providing services itself or through a for-profit partner is addressed in the economic literature on privatization. As Hart,

ure" can afflict contracts with the government as well as contracts with individual market participants.

What can the government do if "contract failure" prevents it from contracting effectively with for-profit providers of public goods? Most obviously, it can provide the services itself, using its own employees.[145] These employees are usually compensated with "fixed" salaries, and so the use of such employees to provide public goods replicates the "non-distribution constraint" as a solution to the agency-cost problem.[146] Collecting tax revenue is perhaps an apt example of why the government may choose to use its own employees rather than a for-profit firm to provide a public good. A "high-quality good" for the purposes of tax collection is collecting the taxes that are owed under the law. This is an inherently difficult thing for the government to measure ex ante, and thus to construct a contract that would effectively define the proper collection would be prohibitively expensive. It is presumably easy to attempt to maximize tax revenue by aggressively pursuing non-meritorious claims, but this approach would not be in the government's interest. The government has determined that the potential efficiency gains to be derived from providing financial incentives to those actually enforcing the tax laws are less than the costs of effectively monitoring whether they are providing a high quality product or whether they are enriching themselves by shirking on quality.

B. The Government's Provision of Public Goods Through Tax Benefits

Thus, when the government seeks to provide charitable goods, it should perform some sort of agency-cost analysis to decide if it should provide those goods through a "for-profit" or a "nonprofit" mecha-

Shleifer, and Vishny point out, "[T]he fundamental difference between private and public ownership concerns the allocation of residual control rights . . . ." Oliver Hart, Andrei Shleifer & Robert Vishny, *The Proper Scope of Government: Theory and an Application to Prisons*, 112 Q. J. ECON. 1127, 1129 (1997). They conclude that "the private contractor's incentive to engage in cost reduction is typically *too* strong since he ignores the adverse impact on quality." *Id.* They also argue that "providing an agent with strong incentives to pursue one objective, such as profits, can lead to his shirking on other objectives, such as quality." *Id.* at 1131.

[145] Rob Atkinson has recently pointed out that defenders of nonprofit charity often imply that government provision of charitable goods is somehow inherently less efficient than nonprofit provision of those same goods. *See* Atkinson, *supra* note 15, at 249. I do not mean to imply that. Rather, each compensation structure has its own efficiencies and inefficiencies that apply differently in different situations.

[146] There are also mechanisms available to the government that occupy an analytic category between contracting with a for-profit firm and providing the services itself, such as cost-plus contracting and providing incentive pay to government employees.

nism. If it chooses a nonprofit form, then it can provide the goods "itself" by using its own employees or it can provide them indirectly through a nonprofit partner. But the question that I seek to answer here is not whether the government should always provide charitable goods through nonprofit firms, but whether the government should require the non-distribution constraint when it seeks to provide charitable goods through *tax benefits*. The theory of "dual contract failure" seeks to explain why it is beneficial for the government to provide at least some charitable goods through tax benefits, instead of directly.[147] The agency theory provides another justification for the government providing charitable goods through tax benefits instead of directly, specifically by justifying reserving the deduction of charitable contributions for contributions to *nonprofit* firms.

Generally, theorists have justified the government's provision of public goods through tax subsidies for nonprofit providers by arguing that the government cannot supply optimally some public goods.[148] They posit that because the government cannot correct optimally the "market failure" that accompanies some public goods, the production of these public goods is beset by "government failure" as well. Specifically, "the government will be unable to overcome a market failure when demand for a given public good is heterogeneous, and the amount each voter demands varies."[149] A subsidy for the provision of such goods through the charitable sector thus serves the interests of correcting those market failures that the government is unlikely to correct directly and therefore promotes diversity in charitable objectives.[150]

The agency theory provides another justification for the government providing charitable goods through a deduction for charitable contributions. As discussed above, when the government provides charitable goods directly, it must evaluate each transaction individually and perform a case-by-case analysis of the agency costs involved in ensuring a high-quality product. It would have to review each transaction to determine whether the charitable outcome is eas-

[147] *See generally* Burton Weisbrod, *Toward a Theory of the Voluntary Nonprofit Sector in a Three-Sector Economy*, *in* THE ECONOMICS OF NONPROFIT INSTITUTIONS: STUDIES IN STRUCTURE AND POLICY, *supra* note 16, at 21 (arguing that nonprofits arise to provide public goods that neither the private market nor the government sector would otherwise provide); BURTON WEISBROD, THE NONPROFIT ECONOMY (1988) (same).

[148] *See generally* Weisbrod, *supra* note 147; WEISBROD, *supra* note 147.

[149] Miranda Perry Fleischer, *Generous to a Fault? Fair Shares and Charitable Giving*, 93 MINN. L. REV. 165, 186 (2008).

[150] *See* Saul Levmore, *Taxes as Ballots*, 65 U. CHI. L. REV. 387, 404–09 (1998). For an important recent refinement of this theory, see Benshalom, *supra* note 59.

ily measurable and to craft a means of enforcing the provision of a high-quality product in each case. But the costs involved in investigating each transaction are agency costs. In cases in which the government *does* evaluate each transaction individually, it can make decisions about whether to fund an activity through a for-profit partner, whether to fund an organization through a nonprofit partner, or whether to perform the activity itself. While the government *could* provide its subsidy through tax benefits after conducting a case-by-case analysis of a transaction, this case-by-case evaluation will presumably be very costly.

It is the very nature of tax benefits that they be provided to a relatively broad class of recipients. The laws that define who may benefit and when are written ex ante and structure an indefinite number of individual transactions. The government need not evaluate each transaction individually to determine how it could best minimize agency costs and maximize the efficient provision of the charitable goods it seeks. Given the large number of transactions that tax benefits may apply to, how would the government best structure those benefits to maximize the chance that they are used to provide beneficial goods or services and minimize the agency costs associated with providing such services? Structuring the government's role in the provision of charitable goods inherently reduces agency costs involved in providing such goods.[151]

Even more important than the savings that come from the government avoiding a case-by-case evaluation of how to provide charitable goods, is the government's benefit from the donors' participation in the transaction when it structures the provision of charitable good as a tax deduction. When the government structures its subsidy as a tax deduction, it only provides the subsidy to organizations that taxpayers have identified as worthy of the deduction. Furthermore, providing the subsidy in the form of a deduction forces taxpayers to vote with their wallet, so to speak, by only giving the subsidy to those organizations to which taxpayers make voluntary contributions and in relative proportion to the dollars contributed.[152] This choice of structure for the subsidy allows the government to *leverage* the choices of millions of taxpayers and to use those taxpayers' choices of worthy causes and organizations to make its own decisions about which caus-

[151] Brian Galle argues that a regime that requires "explicit government judgments about the value of a charity's output . . . is precisely what the law of charities, as currently constructed, is designed to prevent." Galle, *supra* note 15, at 1228.

[152] This argument does not apply only to a subsidy in the form of a tax deduction, but also to a tax credit or governmental matching grant.

es and organizations to support.[153] If we could exclude egoistic purposes in an expenditure, then the expenditures that donors make would reflect their judgment about "worthy" charitable causes and institutions.[154] These choices are aggregated in a market mechanism when donors make contributions to charities.[155]

As David Schizer has recently pointed out, when the government provides subsidies for the provision of public goods through a tax deduction, it not only enlists the assistance of taxpayers in choosing causes or providers but it also "recruit[s] private donors to monitor the quality of nonprofits, so that the government can piggyback on these quality-control efforts."[156] It is beyond the scope of this Article to discuss this insight in depth since to do so would involve an analysis of the tools the government could use to identify "trustworthy" donors and those that should not be trusted, which Schizer only be-

[153] The government traditionally restricts the types of organizations that can receive tax-deductible contributions, although there is a case to be made that it should provide the subsidy to any organization to which taxpayers make true contributions. *See, e.g.*, Hansmann, *Rationale*, *supra* note 18, at 88 ("Indeed, the wisest course is probably just to assume, absent evidence to the contrary, that all nonprofits that receive a substantial fraction of their income in the form of donations are operating in an environment of contract failure, and therefore merit the exemption on efficiency grounds."); *see also* JOHN D. COLUMBO & MARK A. HALL, THE CHARITABLE TAX EXEMPTION 193 (1995).

[154] The non-distribution constraint serves to maximize the chances that the services are socially beneficial by *leveraging* the financial choices of donors. Above, I discussed the somewhat elusive question of what exactly donors are trying to do when they donate money to charities. I suggested that at least some of what they are doing is purchasing a benefit for someone other than themselves. I called this other-directed benefit "altruism" even though I conceded that some portion of the altruism they purchase is probably related to the "good feelings" (warm glow) they get from donating. Millions of citizen-donors make choices every year about where to donate their money. If the government could isolate those donations that are in effect purchases of altruism, then they would be gathering a tremendous amount of information about organizations and activities that donors believe improve the world.

[155] Obviously, not all donations are purchases of altruism. Some may be masked payments for private goods or services. The non-distribution constraint is at least one mechanism the government can use to identify the transactions that are purchases of altruism. When the donor cannot benefit financially from the transaction, then the government can rule out financial motivations from the transaction and can make a somewhat more educated guess that altruism motivates the transaction. Thus, we exclude quid pro quo transactions from the definition of "contributions" worthy of the tax deduction. The non-distribution constraint has a role in ensuring that a donor's contribution is "altruistic" by limiting the types of financial returns he can make from giving money to the charity. As discussed *supra* note 84, this Article focuses on the non-distribution constraint's effect on providers of labor, not capital, and thus a full discussion of the importance of the non-distribution constraint's effect on donors and other providers of capital is saved for a later time.

[156] Schizer, *supra* note 15, at 224.

gan to sketch out.[157] But it is enough here to identify the fact that the government's choice of a tax deduction as at least one method for providing a subsidy for charitable goods has the potential to be the most efficient means of providing such goods because of the agency costs saved in leveraging (rather than pointlessly replicating) taxpayer effort.

The ability to leverage taxpayers' choices of cause and organization and the taxpayers' monitoring efforts have immense agency-cost implications for the government. As discussed above, the government could (and does) individually evaluate many possible public and third-party goods and provides the ones that it determines to be socially optimal either through its own employees or through contracts with for-profit providers. This process, however, has costs—agency costs. Finding a mechanism to enlist taxpayer assistance and to piggyback on taxpayer efforts in these processes has the potential to save the government substantial costs. Of course, this strategy can only be effective if taxpayer choice of organizations worthy of charitable contributions generally identifies organizations that actually deserve a government subsidy.

C. So, Why Not Permit Tax-Deductible Contributions to For-Profit Charities? The Theory of Imperfect Consumers

If the government is so keen on leveraging taxpayers' decision-making, then why not permit the taxpayer to make the decision whether to contribute to a nonprofit or a for-profit charity? If agency theory predicts that consumers will select either the nonprofit form or the for-profit form when the respective form is most efficient, then Malani and Posner rightly ask why not just trust consumers to choose the right form to provide charitable goods and subsidize the provision of those goods whether they are provided through a nonprofit or for-profit form? Just because the agency theory predicts that the nonprofit form will almost always be the most efficient way to structure the provision of third-party and public goods is no good reason in itself to condition tax benefits on nonprofit status. Why not give the same benefits to *for-profit* providers of such services if donors want to donate money to them?

One possibility is that the answer has something to do with taxpayer knowledge.[158] That is, to explain the choice of subsidizing *only*

[157] *See supra* note 84.

[158] The answer may also have to do with taxpayers' interests, of course. If the taxpayers' interests diverge from those of the government, then the government cannot trust the taxpayers' choices when it seeks to provide subsidies for charitable goods. A

transactions subject to the non-distribution constraint, we need a theory that explains why taxpayers are good at choosing worthy causes and providers, but potentially not always as good at deciding whether those providers should be nonprofit or for-profit. Remember, consumers are almost always likely to choose a nonprofit provider for charitable goods.[159] What I am looking for is an explanation why, in the rare cases that taxpayers choose a for-profit provider instead, the government may be suspicious of that choice and may decide to refuse to provide tax benefits to the for-profit provider. The agency-cost theory is exactly that.

Malani and Posner briefly describe one possible explanation why the government would choose to restrict tax deductions to nonprofit charities: consumers might choose for-profit providers of charitable goods because they are confused or deceived, and thus it would be ill-advised for the government to rely on their choice of transaction structure when making its own decision to whom to provide its subsidy.[160] The government does not want to provide tax benefits to for-profit providers of such goods if the only reason donors might choose them is because of confusion, ignorance, or fraud. Malani and Posner call this the "Theory of Imperfect Consumers."[161]

Malani and Posner do an excellent job of describing the problem concisely:

> Because the tax break is keyed to the Donor's personal allocation to charities, it effectively delegates power over government expenditure to the Donor. For the same reason that the Donor [may be] a poor decisionmaker for her own allocations, she is a poor agent to control the government's expenditures. This is why the tax breaks must be restricted to firms that cannot distribute profits. It is a way to protect the government from imperfect Donors.[162]

Malani and Posner's primary solution to the problem of "imperfect consumers" is to argue that if consumers are imperfect, then there should be no tax deductions for charitable contributions.[163] If the government thinks that it is appropriate to subsidize the provision of certain goods, like public goods or third-party goods, then it should

treatment of this "theory of diverging interests" is beyond the scope of the present discussion.

[159] *See supra* text accompanying note 63.

[160] Malani & Posner, *supra* note 8, at 2050.

[161] *Id.*

[162] *Id.* at 2051.

[163] *Id.*

choose its own recipients and pay them directly.[164] Malani and Posner state, "[T]he government can purchase public goods through ordinary procedures for government procurement, which include competitive bidding."[165]

As discussed above, Malani and Posner's suggestion risks losing a tremendous quantity of potential efficiency gains if taxpayer choices have any value. If the government went through its own process of choosing public goods and providers, it would lose the value of leveraging taxpayer choices. It would also lose the ability to save its own agency costs by piggybacking on the monitoring ability of a large and diverse market for charitable goods.

Malani and Posner acknowledge that there is a value in the government providing some avenue other than the political process for citizens to choose priorities of government spending on public goods.[166] In response, they suggest an alternative plan: if the government wants to provide some direct input from citizens about what to fund, they should let citizens choose (for example on their tax returns) a type of *activity* that should be funded; then "the government would accumulate these dollars [allocated by citizens] and choose an organization to receive such dollars."[167] The government could then subsidize an organization of its own choice that conducts the activity chosen by the taxpayers.[168] In this proposal, the government maintains the benefits of taxpayer choice of *activity* but gives up the benefits of leveraging taxpayer choice of *organization*, as well as the benefit of donor monitoring discussed by Schizer. Furthermore, by simply voting to allocate federal dollars, the taxpayer is less invested in her choices. It is plausible to conclude that a taxpayer pays more attention even to the choice of activity when she is contributing her own money to support it than when she simply makes a preference known on a piece of paper sent to the government. This proposal, then, while slightly better than just repealing the deduction for charitable contributions, still risks losing the potential value of leveraging a

[164] *Id.* at 2052. Malani and Posner also cover their bases by arguing that "imperfect consumers" are not a problem because consumer-protection laws can protect them against fraud. *Id.* at 2051. Of course, fraud is only one reason why consumers are imperfect, and anti-fraud laws provide limited protection even against fraud.

[165] *Id.*

[166] Malani & Posner, *supra* note 8, at 2030 (explaining that the "public goods theory" justifies the government providing a tax subsidy for the provision of charitable goods, and stating that "we will assume that it is correct for the purposes of our argument").

[167] *Id.* at 2051.

[168] *Id.*

market of taxpayer choices of providers and taxpayers' monitoring of quality.

Neither proposal is necessary, however, if taxpayer ignorance does not apply equally to all choices taxpayers must make in choosing a charity. Taxpayers may be quite adept at choosing the types of charitable goods that are worthy of support and even the organizations that should be supported, but sometimes, they are poor choosers whether to compensate the entrepreneurs who provide such charitable goods with a "profits" interest. Remember, taxpayers have to be good enough only at choosing activities and organizations that make their aggregated choices better and cheaper than those made by the government. Thus, Malani and Posner's response to the possibility of taxpayers' ignorance is an overreaction if taxpayers' ignorance is related specifically to the choice of the non-distribution constraint and is not more inclusive.

Why might we assume that the small number of consumers who choose the for-profit form to provide charitable goods do so because they are ignorant, confused, or deceived? First, the nonprofit form is so prevalent for providers of charitable goods that donors might assume that any provider of charitable goods is bound by the non-distribution constraint. People are genuinely confused by the distinction between "nonprofit" organizations and providers of charity. They assume that they are the same thing. Therefore, consumers who choose for-profit providers of charity may think those providers are constrained like nonprofits when in fact they are not.[169]

But even more importantly, the whole point of the non-distribution constraint is that the donor's agency costs are minimized if he largely *delegates the monitoring and enforcement of the constraint to the government*. In other words, contract failure means that consumers cannot do what they ordinarily do in a transaction—monitor the quality of the goods provided. In response to this contract failure they substitute something that can be monitored—compensation to the entrepreneur—and hope that because the entrepreneur cannot personally use the excess value, the excess value will be used to provide charitable goods. They retain some ability to monitor the non-distribution constraint (for example, by looking at the entrepreneur's compensation on the charity's Forms 990), but they mainly delegate

[169] For example, people asked to contribute to organizations in traditionally charitable areas, like education, may assume that those organizations are nonprofits, or are somehow constrained by something like the non-distribution constraint, even when they are not.

that responsibility to the government.[170] The government then monitors and enforces the non-distribution constraint with respect to the charity's management. Agency costs are reduced sufficiently thereby that a market for charitable goods is possible.

If donors depend on the government to monitor the non-distribution constraint, then it makes perfect sense that they may sometimes be confused about it. The donors rely on the government to prevent the entrepreneur from pocketing their contributions when, in fact, there may be nothing in their agreement with the entrepreneur preventing such result. Thus, it is entirely reasonable for the government to reach the conclusion that the non-distribution constraint is necessary to the efficient provision of public and third-party goods. The donor is implicitly depending on it. It is also entirely reasonable for the government to maintain this conclusion even in the rare case in which a donor wants to provide charitable goods through a for-profit organization. That donor may well be confused about the effect of removing the non-distribution constraint in that case. This confusion does not call into question the value of the donors' (the market's) choices about what charitable goods are worth funding and what organizations are the best providers of them. It is limited to an unusual choice about something that the structure of the transaction generally requires the consumer to delegate to the government.

Therefore, in the usual case in which no compelling measure of quality can be identified in a cost-effective way, the government should insist on providing a tax deduction for contributions *only* to nonprofit charities, even if some confused donors would prefer to contribute to for-profit charities.

D. What About Malani and Posner's Hypothetical?

In Part II, I discussed the fact that Malani and Posner's example of a "for-profit" charity was one in which the entrepreneur had identified a plausible definition of a high-quality charitable good for the donor. In that hypothetical, the entrepreneur had promised the donor that eighty percent of all contributions would "go to" poor African children.[171] Assuming that it is possible, at least conceptually, for "go to" to have a meaning, the eighty percent promise constitutes a

[170] As Schizer points out, their monitoring may still be robust under certain circumstances. Schizer, *supra* note 15, at 258.

[171] For previous discussion of this hypothetical, see *supra* notes 119–121 and accompanying text.

meaningful definition of a high-quality good. Malani and Posner then posited that the remaining twenty percent of every contribution would be split between "administrative costs" and compensation for the entrepreneur.[172] They argued that permitting the entrepreneur to keep whatever money she saves from providing administrative services relating to the charity more cheaply than was predicted would promote efficiency.[173] That would incentivize her to find the most efficient way to provide those services. Assuming that "administrative costs" are such that there is no way for the entrepreneur to enrich herself by shirking on the quality of those services, this claim is plausible. If the government prevented that kind of arrangement, then it seems that it might be doing us all a disservice by preventing an efficiency-enhancing structure from being adopted.

In the next Part of the Article, I survey the current law relating to compensation of charity managers and find that what Malani and Posner call a "for-profit" compensation structure is actually perfectly compatible with the nonprofit form under current law. But before moving on, it is worth pointing out that the government's own agency-cost analysis may rationally require that the government prevent what might, in some specific circumstance, be the most efficient structure for a transaction. That is because if the government is to reduce agency-costs in the provision of charitable goods, it has to make rules that are *generally applicable* to whole classes of transactions, and it needs to be able to enforce the same rules to a very large number of transactions. The main agency cost that the government seeks to save when it provides a subsidy for the provision of charitable goods in the form of a tax deduction is the cost involved in evaluating each transaction, customizing a contract to govern that particular transaction, and enforcing multiple different contractual terms. For the non-distribution constraint to work, the government needs to identify something it can observe (compensation to charity employees, for example), it needs to make rules about which types of compensation are permissible and which are not, and it needs to enforce those rules. The health of the nonprofit sector depends on the government being able to do that well and cheaply. Thus, if a particular compensation structure *generally* reduces efficiency, the government may choose to prevent organizations from using it even if it may enhances efficiency in certain specific circumstances.

[172] Malani & Posner, *supra* note 8, at 2027.
[173] *Id.*

For example, Malani and Posner point out that a for-profit firm "can promise Donors, by contract, that it will not distribute profits to its managers or workers."[174] They argue that these private contracts could be "part of the sales contract for that product," and that the entrepreneur could "hire an auditor" to ensure that the for-profit charity is abiding by the terms of the contract.[175] Since for-profit firms can replicate the non-distribution constraint through private contracts of various sorts, Malani and Posner ask why they should not be permitted the same tax benefits as nonprofit firms that constrain themselves through the non-distribution constraint provided under the Internal Revenue Code.[176]

The problem with allowing tax-deductible contributions to for-profit firms that engage in these types of private contractual substitutes for the non-distribution constraint is simply that these constraints are *private* contracts. From the government's perspective, it is reasonable 'to provide governmental subsidy only to transactions that, in effect, use its own standardized contractual terms.[177] If the government needs to monitor and enforce the terms of the agreement, then of course it wants those terms to be standard. The law of tax-exempt organizations is the set of standardized terms under which the government provides subsidies to providers of charitable goods. The non-distribution constraint is the heart of that set of standardized contracts, and the government is rational in its choice to value generality, administrability, simplicity, and enforceability as parts of its own agency-cost analysis when deciding which transactions to subsidize.[178]

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[174] *Id.* at 2035.

[175] Malani and Posner also suggest that the for-profit firm could institute a "cost-plus pricing system" by "billing the donor after all costs have been tallied and the product has been delivered." *Id.* at 2036. This cost-plus system would presumably also be defined in a private contract and enforced through regular contract law.

[176] *Id.* at 2060. For a response, see generally Hansmann, *Reforming*, *supra* note 16, at 516–18.

[177] *See, e.g.*, RICHARD POSNER, ECONOMIC ANALYSIS OF LAW 85 (2d ed. 1977) (stating that a seller might employ a standard or form contract when "he wishes to avoid the costs involved in negotiating and drafting a separate agreement with each purchaser [since] [t]hese costs are likely to be very high for a large organization that engages in so many transactions that it must adopt routine procedures for the guidance of its line personnel").

[178] After recognizing that private parties could create private contractual forms of the non-distribution constraint, Hansmann notes that "[t]he advantage of the non-profit form, then, is that it economizes on contracting and enforcement." Hansmann, *Role*, *supra* note 16, at 853. This Article points out that it economizes on enforcement not only for the donors, but also for the government, even though the

Malani and Posner's example of the organization that promises to cause eighty percent of the funds to "go to" the African children is a case in point. Even though this "hybrid" model—in which the non-distribution constraint is confined to one part of the agreement—may be more efficient than a strictly nonprofit model under certain specific circumstances, it would be rational for the government to refuse to provide a tax deduction for contributions to such a structure. That is because the government might conclude that the agency costs saved by enforcing a single standard non-distribution constraint outweigh those efficiency gains potentially available from permitting organizations to isolate administrative costs by customizing a private non-distribution constraint. Thus, the coupling of the non-distribution constraint with tax benefits for donative charities is justified by the government's need to reduce agency costs by providing a standard set of rules about permissible compensation.

The next Part of this Article surveys current law and finds that it permits nonprofits to use the hybrid structure described by Malani and Posner. In other words, entrepreneurs may customize many possible incentive compensation structures while still permitting their donors to receive a deduction for their contributions. The entrepreneurs are only prohibited from tying compensation directly to profits. That is, they can receive the precise incentives that Malani and Posner think would add efficiency to the provision of charitable goods. But entrepreneurs must do so in a way that does not egregiously permit the providers of charitable goods from profiting by shirking on quality—the exact concern the non-distribution constraint is designed to address.

IV. COMPENSATION AND THE NON-DISTRIBUTION CONSTRAINT UNDER CURRENT LAW

I noted previously that any transaction that solves the non-divisibility problem associated with the provision of public and third-party goods identifies a measurable output to which compensation can be tied. Malani and Posner's hypothetical does this in a way that expressly mimics the non-distribution constraint by setting a fixed percentage of all donations that must be used for charitable purposes and permitting the entrepreneur to keep any of the remaining money she does not spend on "administrative costs." But I suggested other possibilities, like agreements in which an organization would provide a set quantum of clean water for African villagers for each dollar

government assumes the enforcement role when the standardized non-distribution constraint known as "nonprofit law" is adopted.

contributed. This structure also identifies a measurable output that defines a quality good and makes it possible to structure a transaction in such a way that the entrepreneur would keep any money left over after the set quantity of water is provided to the agreed-upon number of African villagers.

Malani and Posner argue that the compensation in their hypothetical would not be permitted to a nonprofit firm under nonprofit law,[179] and by extension, it would be easy to assume that the compensation described in the second example would also not be permitted. In their conclusion, Malani and Posner make a compromise proposal: "[I]f one is uncomfortable with giving for-profits access to nonprofits' tax breaks, a compromise may be to allow nonprofits to access for-profits' incentives."[180] They argue that the IRS should "relax the restriction" on nonprofit managers' compensation that does not allow nonprofit managers to "receive incentive pay keyed to the profits, to the revenues, or perhaps even to the costs of operating the organization."[181]

In fact, however, while the Internal Revenue Code probably restricts compensation tied directly to the profits or revenues of a nonprofit firm, output-specific variable compensation structures are both theoretically consistent with the non-distribution constraint and permitted under current law for nonprofit managers. In other words, the incentive compensation structure described in the Malani-Posner hypothetical and in my extension of it is permitted under current law. Structures based on true profits are not permitted. This distinction under current law makes perfect sense as an expression of the agency-cost analysis of the government's provision of tax benefits for charities.

In this Part, I discuss briefly the ways in which current law does not conform to the simple distinction between *for-profit* and *nonprofit* organizations described by Malani and Posner. This is important because if current law permits the kind of efficiency-enhancing compensation structures that Malani and Posner associate only with for-profit firms, then the argument in favor of reforming the law to expand the tax-subsidies provided to for-profit firms is even less persuasive.[182] It is also important because the agency-cost analysis presented

[179] *See* Malani & Posner, *supra* note 8, at 2019 ("Unfortunately, under current law, the Entrepreneur cannot establish her charity as a nonprofit organization.").

[180] *Id.* at 2065.

[181] *Id.*

[182] It is also true that tax-deductible contributions can be provided to true for-profit firms providing charitable goods as long as some charitable intermediary is

in this Article provides a principled method for determining which incentive-pay structures *should* be permitted to charitable organizations. Good pay structures are those in which managers' pay is tied to some measurable output so that managers' compensation cannot be increased by *reducing* the quality of the charitable good provided. If a manager can increase her compensation by reducing the quality of the good provided—as is the case when compensation is tied directly to profits or revenues—agency costs will simply be too high when the product is largely invisible to the donors and the government. Thus, to the degree to which current law draws the line between compensation tied to measurable output and compensation tied to profits, it draws the line in the correct place. Even more importantly, to the extent that there is ambiguity in the law—and there is plenty—this agency-cost method should provide a guide for decisions about what compensation structures to permit. This method can be used by donors, by charity boards of directors, by the IRS in administering the law, and by critics or reformers of current law.

Malani and Posner argue that nonprofit organizations must pay their managers fixed salaries, and only for-profit firms are permitted to pay their managers profits-based compensation.[183] This bilateral distinction does not adequately model reality, however. In fact, it is

used. This is easily accomplished. A nonprofit charity that meets the requirements of §§ 501(c)(3) and 170 is created, and it accepts tax-deductible contributions. It then takes the money contributed and contracts with a for-profit provider for the charitable goods. There is nothing impermissible about a charitable nonprofit organization providing charitable goods by contracting with a for-profit supplier. So, for example, an organization whose purpose is to provide water to African children could contract with for-profit partners who will build the wells or do the actual supplying. These contracts would presumably be only subject to the "private benefit" restrictions, and thus it would be the obligation of the charity's board to ensure that it used reasonable diligence in determining that its contract is a fair one and that charitable assets are not wasted. Thus, while it is true that *retail-level* individual donors may not make tax-deductible donations to for-profit firms, tax-exempt organizations (both private foundations and the so-called public charities) are permitted to funnel the money raised through tax-deductible contributions to for-profit firms providing charitable services. Malani and Posner briefly address a structure similar to this possibility under the rubric of "sophisticated legal manipulation" that could permit tax benefits for contributions to for-profit firms. *Id.* at 2056. They argue that this solution is not sufficient because it does not permit the manager of the *nonprofit* to be compensated with a profits interest in the for-profit firm. *Id.* at 2057. While this is plausible as a matter of law, it is not clear why it is a compelling objection. The managers or directors of the nonprofit act as monitors and guarantors of the charitable interests of the donors and others, but they are not the people whose purpose or expertise is to find efficiency gains in delivering those goods. That is the job of the manager of the for-profit, who can be compensated with a profits interest in the for-profit firm.

[183] *Id.* at 2024.

more useful to describe the entrepreneur's possible compensation options under current law as a pole with "fixed" salary on one end and "profits" on the other end. In the middle is a range of compensation options that may be called "incentive pay." A "fixed" salary means that the entrepreneur gets paid the same amount no matter what she does—her salary is presumably fixed at the beginning of her relationship with the donors, so neither she nor they know yet what types of cost-saving mechanisms she may find or invent. A "profit-based" salary means that her pay varies based only on the difference between the total amount of money the firm takes in (presumably from donations in the case of donative nonprofits) and the total amount spent on health for African children and any other administrative costs of providing that health (this difference is called "profits").[184] But "incentive pay" means anything between these two extremes. Thus, between the "fixed" compensation structure and the "profits-based" compensation structure are various "incentive" compensation structures that tie compensation to identifiable outcomes *other than profits*.

The tax law governing permissible compensation for organizations that receive tax-deductible contributions can be confusing, partially because the law is different depending on whether the compensated individual is a "disqualified person" or not.[185] But, generally, even if the entrepreneur is a disqualified person, she may pay herself a variable salary based on some quantifiable factor other than net profits.[186] If certain procedural safeguards are implemented, the

[185] Generally, a "disqualified person" with respect to a public charity is "any person who was . . . in a position to exercise substantial influence over the affairs of the organization." 26 U.S.C. § 4958(f) (2006).

[186] Generally, punitive excise taxes may be levied against organizations that engage in an "excess benefit transaction," which is defined as "any transaction in which an economic benefit is provided by an applicable tax-exempt organization . . . to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration . . . received for providing such benefit." § 4958(c)(1)(A). In other words, *excessive* compensation may result in excise taxes, but reasonable compensation will not. Reasonable compensation is defined as "the amount that would ordinarily be paid for like services by like enterprises . . . under like circumstances." Treas. Reg. § 53.4958-4(b)(1)(ii)(A) (2012). If a compensation structure is defined as "fixed" for the purposes of the regulations, then the relevant time for determining reasonableness is the date the parties enter into the contract. *Id.* § 53.4958-4(b)(2)(i). But a "fixed" compensation structure does not mean one in which the total amount of compensation is negotiated in advance. Rather, "fixed payment means an amount of cash or other property specified in a contract, *or determined by a fixed formula specified in the contract*, which is to be paid or transferred in exchange for the provision of the specified services." *Id.* § 53.4958-4(a)(3)(ii)(A) (em-

charity may even rely on a rebuttable presumption that the compensation paid to the entrepreneur is reasonable even if the compensation varies based on some measurable output and even if the entrepreneur is a "disqualified person."[187] Commentators have also noted that incentive compensation arrangements are permissible, so long as variable pay is tied to some metric of performance.[188]

For example, take Malani and Posner's hypothetical.[189] The donors and the entrepreneur agreed that the donors would pay one hundred dollars, of which eighty would go directly to the benefit of the African children. If the entrepreneur can figure out how to re-

phasis added). The "fixed formula" may relate to future contingencies, "provided that no person exercises discretion when calculating the amount of a payment or deciding whether to make a payment (such as a bonus)." *Id.* Thus, a compensation structure in which the entrepreneur is paid a variable amount based on some quantifiable factor would be a "fixed" compensation structure and would be permitted so long as the amount that was expected to be paid was "reasonable" at the time the contract was entered into. For example, in I.R.S. Priv. Ltr. Rul. 2006-01030 (Jan. 6, 2006), the IRS found that a certain incentive compensation arrangement in which compensation was tied to meeting specific performance objectives did not constitute inurement. *See also* I.R.S. Gen. Couns. Mem. 39674 (Jun. 17, 1987); I.R.S. Gen. Couns. Mem. 38905 (Jun. 11, 1982); I.R.S. Gen. Couns. Mem. 38283 (Feb. 15, 1980). *But see* People of God Cmty. v. Commissioner, 75 T.C. 127, 133 (1980) (holding that a "percentage-of-gross-tithes" method of fixing compensation constituted private inurement); Gemological Inst. of Am. v. Commissioner, 17 T.C. 1604, 1609 (1952) (holding that compensation measured as a percentage of "net earnings" constituted private inurement).

[187] Generally, a rebuttable presumption in favor of reasonableness is created if (1) the compensation arrangement is "approved in advance by an authorized body . . . composed entirely of individuals who do not have a conflict of interest," (2) "the authorized body obtained and relied upon appropriate data as to comparability" of the compensation arrangement, and (3) "the authorized body adequately documented the basis for its determination concurrently with making that determination." Treas. Reg. § 53.4958-6(a) (2011). Of these, the only difficult requirement is that the organization obtain "appropriate data as to comparability" to support a compensation arrangement in which payments vary based on some measure of output. But so long as other organizations (nonprofit or for-profit) are paying their management in this way, it is permissible for a nonprofit charity to pay in this way.

[188] *See, e.g.*, Peter Frumkin, *Nonprofit Compensation and the Market*, 21 U. HAW. L. REV. 425, 434 (1999) ("[I]f compensation fluctuates, the organization should be able to attribute the fluctuation's relationship to the employee's performance."); Sandra B. Richtermeyer & Gary Fleischman, *Planning Strategies to Avoid Intermediate Sanctions*, 36 TAX ADVISER 424, 431 (2005) ("The use of incentive compensation is becoming more popular, particularly as nonprofit organizations compete with the private sector for executive talent. It is critical to link incentive or bonus pay to specified identifiable goods (such as organizational performance), particularly for highly paid executive directors or officers."). *See generally* Brody, *supra* note 16, at 494 ("[T]he law generally permits competitive returns to labor; the non-distribution constraint bars only returns to equity capital.").

[189] For previous discussion of this hypothetical, see *supra* notes 119–21 and accompanying text.

duce the indirect administrative costs of providing water without reducing the money used directly in Africa, then she can keep one hundred percent *of the savings in administrative costs.*[190] Malani and Posner posit that a compensation structure in which the entrepreneur can keep any of the remaining twenty dollars not spent on administrative costs would not be permissible for a nonprofit organization.[191] But actually, under current law, an incentive-pay structure that identified some reasonable amount of administrative costs and permitted the entrepreneur to keep any savings in administrative costs as their own compensation would likely be permitted.[192]

This compensation structure would not be a per se violation of the non-distribution constraint. Rather, it would have to be evaluated to determine whether it is reasonable compensation for the entrepreneur's services. This analysis would presumably begin with the "rebuttable presumption" provided under Section 53.4958 of the Treasury Regulations, in which an independent committee of the board would make a determination of the compensation structure, document it, and gather evidence that the overall structure is comparable to compensation arrangements made elsewhere.[193] Then, as long as the compensation structure is reasonable overall, the fact that it is tied to some objective measure of success, such as reducing administrative costs above what was previously expected, would not in any way be problematic for a nonprofit charity.

The binary opposition proposed by Malani and Posner is misleading, and the situation described in their own hypothetical, once fleshed out, is equally available under current law to for-profit and nonprofit charities. What distinguishes this permissible incentive-pay structure from an impermissible profits interest? Nothing more than the fact that *the firm has identified a measure of success—an outcome that is not tied to net profits of the firm.* That measure of success is the reduction in administrative costs associated with the particular project.

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[190] Presumably, they would also agree that her compensation would be reduced by any cost she incurs over the predicted administrative costs.

[191] *See* Malani & Posner, *supra* note 8, at 2019. In this regard, Malani and Posner's claim that the IRS will not permit nonprofit managers to receive compensation tied to the costs of operating an organization appears to be just wrong. *See id.* at 2065 ("[T]he IRS does not permit managers who exercise control over a nonprofit to receive incentive pay keyed to . . . perhaps even to the costs of operating the organization."). They provide no authority to support the claim, and it appears to be inconsistent with current law.

[192] As discussed *supra* note 112, it is unlikely the donors would permit the entrepreneur to keep 100% of the efficiency gains. She would likely have to split some portion of the gains with the donors in some way.

[193] *See* Treas. Reg. § 53.4958-4 (2002).

Malani and Posner's hypothetical replicated the non-distribution constraint under private contract terms, so it is not surprising that it is permissible under current law. But what if the organization identified a measurable output as a definition of a quality product and compensated a CEO who managed to outperform the predicted cost of providing quality products? In this case as well, current law permits incentive-pay structures for organizational managers. Imagine that the organization promised that for each one hundred collected, water would be provided to one hundred additional African children and that it had solved the "non-divisibility" problem in some way so it was easy and cost-effective to verify that each additional dollar contributed would provide water for an additional unique African child. Imagine that the organization decided to provide incentive compensation to its CEO and agreed that if the CEO could provide water for the same number of African children at less than one dollar per child, then she could keep the savings.

Again, in this case, current law would probably permit the proposed incentive-compensation arrangement. Again, the analysis would begin with the "rebuttable presumption," under which an independent committee of the board would gather evidence that the overall structure is comparable to compensation arrangements made elsewhere, make a compensation contract prior to paying compensation, and document everything.[194] Then, as long as the presumption is not rebutted, the compensation would not be problematic. Again, the fact that compensation is tied to meeting some performance goals, like providing water to a certain number of additional children per dollar spent, would be entirely acceptable under nonprofit law.

Then, in at least these cases, the permissible "incentive" pay structure provides all the benefits of the "profit" pay structure proposed by Malani and Posner. But these are not pure "for-profit" compensation structures. In neither case can the entrepreneur keep any money not spent on providing water to African children. Instead, in both cases some measurable output is identified, and the entrepreneur can only keep money left over after providing charitable goods of a quality that can be measured.

As discussed above,[195] this is an unusual situation in the provision of charitable goods.[196] More often, the provision of charitable goods

[194] *See id.*

[195] *See supra* Part II.B.4.

[196] The fact that incentive-pay structures are not more widely used by charities, despite the fact that they are permissible under current law, supports the observation that the ability to measure success in observable ways is unusual. As discussed *supra*

will be accompanied by more pervasive contract failure. That is, the costs associated with identifying and monitoring the provision of measurable high-quality goods will overwhelm any potential savings to be derived from such incentive-pay arrangements.

As discussed above, if the entrepreneur's pay was not tied to some measurable outcome—like savings in administrative costs—but instead was tied to net profits alone, the entrepreneur could simply provide *less* benefit and *keep* the money. If she found that she could provide water to one hundred percent of the children in the village for ninety dollars (keeping her predicted ten dollar fee) or that she could provide water to only fifty percent of the children for seventy dollars (bumping her compensation to a healthy thirty dollars), then there would be nothing in the for-profit structure that would prevent her from doing so. In other words, if a "high quality product" cannot be defined, or if effective means of monitoring and enforcing the quality of the product cannot be implemented, then the profits-pay structure will usually be unattractive to the donor.

Malani and Posner create a hypothetical to illustrate why a profits-based structure may sometimes be preferable to a nonprofit structure, but in so doing, they create a structure that is permissible for nonprofits under current law. An *actual* for-profits structure, one in which the entrepreneur really has access to the net profits of the firm, unconstrained by some mechanism to restrict her compensation to some measurable output, would result in an obviously unacceptable cost—the unprotected risk of the entrepreneur profiting from providing a low-quality product. The fact that incentive-pay structures are consistent with the non-distribution constraint under current law suggests that there are unlikely to be many situations in which a donor accurately identifies a situation in which the most efficient transaction structure is a for-profits model. In this case, if a donor chose the for-profit structure, the government would be reasonable to deny a tax deduction for such a contribution.

But more importantly, this line between incentive-pay structures, in which compensation is tied to some identifiable output measure, and profits-based pay structures, in which compensation is tied to the difference between revenue and costs, not only describes the line drawn by current law but it also provides a principled method of as-

Part II.B.3, donors generally do not have good information about the best means to improve the health of African children or what the competing costs and benefits may be. They do not know the types of cost savings that the entrepreneur may institute because they do not know what the reasonable costs for providing the services they seek would be. Instead, they rely on a fixed salary and the non-distribution constraint to secure the most efficient transaction structure.

certaining what compensation structures *should* be permitted in charitable organizations. Thus, the IRS could expand its guidance on managerial compensation building on the insights presented here. The key is whether a compensation scheme enables managerial compensation to be increased when the managers reduce quality. Those compensation structures that are most likely to permit such enrichment by quality reduction, like a pure profits interest, should be prohibited since they do not advance the government's interest in the efficient use of its tax subsidies for charitable goods. The agency-cost focus also highlights the importance of the government identifying those persons who share its interest in high-quality charitable goods. Charity managers who stand to increase their compensation by reducing product quality do not share the government's interest.[197]

V. CONCLUSION

If the current law is generally adequate in the way it deals with the non-distribution constraint and its effect on manager compensation, then what justifies this Article? What is it about the claim that "tax breaks" for charitable goods should be "decoupled" from the non-distribution constraint that demands such an extensive reply? The primary answer is that Malani and Posner's attempted "refutation" of the so-called agency theory provides a timely opportunity to expand that theory and to investigate its application to decisions about how to compensate the managers of the providers of public and third-party goods. In short, the conclusion of the first part of this Article is that donors to charitable goods' providers are probably choosing the most efficient mechanism to deliver such goods when they choose to provide them through nonprofit organizations, despite any efficiency costs of providing them in such form.

But the implications of the agency theory are wider than simply justifying the donors' choice of providing charitable goods through nonprofit providers in most circumstances. Rather, this Article also proposes some criteria for evaluating incentive-pay arrangements by charities, nonprofit or otherwise. The agency-cost analysis described in this Article should provide a useful guide to anyone making decisions about whether incentive compensation arrangements are effi-

[197] As I have pointed out elsewhere, this attention to the government's agency costs may justify the IRS's interest in whether a charity has an "independent" governing board or other "independent" stakeholders. *See* Benjamin Moses Leff, *Federal Regulation of Nonprofit Board Independence: Focus on Independent Stakeholders as a "Middle Way,"* 99 KY. L.J. 731 (2011).

ciency promoting or inefficient. If a performance measure can be identified and monitored at a sufficiently low cost, then tying manager compensation to that measure may be efficiency enhancing. That is, efficiency may be enhanced so long as the manager cannot enrich herself by shirking on quality of product. When the product is altruism or has an altruistic or public-good aspect, then the quality of the product is likely to be expensive to monitor or measure, and thus managers may well have an opportunity to cut costs by reducing quality. Performance measures that enable them to enrich themselves by cutting costs at the expense of quality are likely to be inefficient. A pure profits interest in a firm, in which compensation is tied directly to the difference between revenue and costs, enables managers to increase their compensation by cutting costs in ways that directly impact product quality. That is why true for-profit charities are inefficient.

But Malani and Posner's argument about tax benefits also provides the opportunity to enlarge the agency theory to explain why donors who are tempted to choose to provide such goods through for-profit providers should be denied tax benefits for that choice. The *government* has its own agency costs to worry about, and it is reasonable for the government to provide a single standard that will most often maximize the efficiency of providing charitable goods through tax benefits. This is especially true because there are plausible explanations why the government might be suspicious of donors seeking tax benefits for the provision of charitable goods through for-profit firms. The goal of the tax law of charitable organizations, then, should be to provide a standard set of rules that constrain the compensation of the managers of charitable firms that maximize the efficiency of the government's provision of charitable goods through tax incentives. The current state of the law, which permits incentive compensation arrangements so long as they are tied to some metric (some output measure) other than profits or revenues, conforms well to the intuitions formed by thinking through what the agency theory predicts. In addition, to the degree to which the standard under current law will be further clarified and developed, agency theory suggests that the key factor in deciding whether incentive-pay structures are efficiency enhancing is whether product quality can be identified and monitored in a cost-efficient way by someone whose interest lies in maximizing product quality. If it cannot, then managers may be incentivized to reduce quality. It is in the government's interest to prevent those types of incentive-pay arrangements.

Finally, I mentioned in the introduction that the non-distribution constraint affects the way both providers of labor and

providers of capital are compensated. This Article has focused on justifying the non-distribution constraint's limitation of compensation for providers of labor. But an adequate treatment of whether the non-distribution constraint's limitation on providers of capital is justified under an agency cost analysis is still to be performed. The reasoning of this Article suggests that providers of capital must be denied a true profits interest in charitable firms receiving tax benefits *if* they have any control rights over the operation or management of the firm. If "ownership" and "control" could be separated in a truly fundamental way, then it is possible that providers of capital could be compensated with the profits of a firm without risking excessive losses from shirking on quality. It is unlikely that people would want to provide capital under these circumstances, again because of agency costs, but a full-scale exploration of this possibility is warranted.