THE ORIGINS AND PURPOSES OF NOT FOR PROFIT ORGANIZATIONS

BY

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I. Introduction

How does the structure and form of an organization shape its specific goals, and what form of organization leads to the most socially efficient way to achieve specific goals? These questions confronts every entrepreneur (in the wide sense) who seeks to engage in some new activity that requires a scale of endeavor beyond the single-individual. The choices range from private to public, and within each, a wide array of choices. Consideration of the benefits and costs of using each of these choices parallels to some extent the analysis by former Harvard University law school dean Robert Clark, who considers the optimal form of social control (laws, markets, social custom) in various settings (ref. Law, Markets and Morals).

In the public sector (confining the discussion to the United States) the choices involve Federal, State, local, and special district (single purpose) governmental bodies, plus myriad quasi-governmental corporations and agencies that have some features of private and some features of public enterprise. For some activities (e.g., national defense) the public sector is the obvious choice, and for many (most specifically, manufacturing) the advantages of incentives available in the private sector invariably lead to private sector production. The advantages in general (to the entrepreneur) of using public organizations include the ability to tax the citizenry to support the activity and (in some cases) shelter from legal requirements otherwise imposed on the endeavor. The major problem, from an economic viewpoint, is the loss of appropriate economic incentives that usually come with governmental ownership and control (refs. to Douglass North on property rights).

In the private sector, a dizzying array of organizational forms have emerged, but for our purposes here, we can concentrate on the primary division between for profit (FP) and not for profit (N(FP)) enterprises. The former set includes most importantly shareholder corporations and partnerships, and these two forms dominate almost all choices of private firms. The NFP form is used for a wide array of organizations, including schools, churches, clubs, museums, libraries, orchestras, and the like, and may depend on quite diverse sources of income (gifts, membership fees, fees for service, or combinations thereof).

The fundamental advantages of the FP form include (a) the ability to raise capital rapidly using both equity and bond markets, (b) the ability to separate ownership from control, thus allowing an increase in scale not available in other forms such as the partnership, and (c) limited liability to shareholders, which reduces the cost of capital in general. Thus, FP corporations are at their very essence capitalistic in both the broad and narrow sense. The intrinsic problems arising in FP firms stem from some of the advantages, particularly in the issue of separation of ownership and control. While this makes a much larger organization feasible, it also creates the now-well-understood problem that the managers of such large firms may have different incentives than the owners, a set of problems known generally as incentive-compatibility problems, also widely considered under the umbrella of “principle-agent” problems (ref. Meckling and Jensen works).

NFP firms carry with them different advantages and disadvantages. The essential legal definition that I will use here focuses on the prohibition of shareholders in the NFP firm. NFP firms are not owned by shareholders and do not have a governing board elected by shareholders, since there are no shareholders. This creates an immediate distinction in terms of the costs of capital: NFP firms by definition cannot participate in equity funding arrangements (at least as normally
considered), but they can accept charitable gifts (which, as we shall see below, may function in a similar manner to equity funding). In addition, the NFP firm is sheltered from an essential economic force confronting FP firms, namely the force towards efficient performance dictated by the threat of a takeover. The other matter arising from the lack of shareholders is the nature of the governing board: since there are no shareholders to vote, the governing board, and indeed, the “owners” of NFP firms, are the “board of trustees” (in whom the trust of the government is placed when the organization is created). And this governing board, in almost every case I can identify, is self-replicating.

The advantages and disadvantages of various organizational forms raise a specific issue: Why do NFP firms exist at all, and if so, why are they located in the sectors of the economy we find them, but not others? In some cases, the NFP form dominates (churches, charitable foundations). In other cases, the FP corporation dominates, most obviously in manufacturing sectors. In other cases still, NFP, FP, and governmental forms may coexist, often in competition with one another. For example, in K-12 education, one sees NFP schools competing against government schools. In the delivery of hospital care, sometimes all three forms exist within the same market. In higher education, government and NFP firms coexist and compete, but with absolutely no meaningful participation from FP firms. The only “pairing” of competition rarely observed is direct competition between FP firms and the government, at least in the US. In many European countries that socialized large production facilities (automobiles, aircraft, etc.), recent history has seen a re-privatization in almost all cases except doctrinaire Communist countries.

Since NFP firms seem to compete in some cases against FP firms and sometimes against governmental organization, but we seldom if ever see direct head-to-head competition, it may be reasonable to generalize that NFP firms sit between government and FP firms in some sort of (poorly defined) continuum, which lead us to the next task of defining more specifically the nature of the NFP organization.

Several scholars have dedicated much of their careers to studying these issues, most notably Burton Weisbrod (see, e.g., Weisbrod, 1977) and Susan Rose-Ackerman (e.g., Rose-Ackerman, 1996). Others have made notable contributions, e.g. Fama and Jensen (JLE, 198x).

II. Stylized Facts About NFP Firms

The following facts characterize NFP firms generally:
• operate in the service sector, but almost never in the manufacturing sector
• generally operate with a local or regional focus, not national
• have a higher quality of service than for profit firms, when they compete
• have a self-perpetuating board of trustees
• are supported by, but do not fundamentally rely upon their tax exemption
• rely on bond financing or gifts for capital projects
• often, but not always, have a church-related history
• invariably rely upon gifts of money, time, or both, for their operations
• almost never take out any market power by expanding in size
• rely on brand name identity less than FP firms (churches are a counterexample)
• “insiders” seldom on boards of trustees, and almost never as chair of the board

Having stated this list, we can immediately find counter-examples, but they are rare. For example, in higher education, some elite colleges and universities (a small handful out of the 3000 higher education schools in the US) actually have evolved into national markets, drawing students from around the country and indeed, from around the world.¹ Many churches of different denominations affiliate nationally or even internationally (as in the case of the Roman Catholic Church, for example), but the local church is the dominant supplier of services.

These facts are all consistent with a general hypothesis that forms the basis for the remainder of this paper:

**Not for profit firms arise and are supported by potential customers through gifts of time and effort in order to bypass natural monopolies arising from scale economies (relative to the size of the local market) that the community would otherwise confront. They create opportunities either to bypass monopoly profits, or to increase quality above the profit-maximizing level, or both.**

To understand the details of this hypothesis, we will have to explore the pricing and quality choice mechanisms of NFP and FP firms, respectively, but before embarking on those discussions, several key points deserve discussion. Most importantly, this hypothesis immediately explains why NFP firms never arise in manufacturing, and seldom if ever in retail trade of commodities.

Manufacturing and retail trade have as an essential feature that the products made and sold can be stored through time and transported through space. The ability to store and transport sets a clear upper bound on the extent of monopoly pricing that any “local monopoly” could sustain. Basically, the maximum markup is the cost of transporting the product from a neighboring economy, and so long as the transportation cost is low relative to the production cost, the issue of monopoly pricing becomes by and large irrelevant. Any local attempt to monopolize (say) the market for brooms would find immediate and forceful competition from broom manufacturers in other regions.

¹ The American Red Cross is a special case, since it was founded and chartered by the federal government.
Services, by contrast, offer natural opportunities for local spacial monopolies to arise and persist, depending on the technology of production. The time and costs of the customer’s travel make service-sector industries a ripe target for natural monopolies unless the optimal scale of the firm is low enough to sustain multiple providers in a single region.\textsuperscript{2} This may explain, for example, why hospitals are organized as NFP corporations but doctors’ offices and pharmacies are almost invariably for-profit enterprises (either as corporations or partnerships), although all of these organizations, perhaps doctors most of all, can crucially affect people’s health.\textsuperscript{3} It may also explain

\textsuperscript{2} This raises a separate question about the relationship between the number of firms in a market and the pricing behavior observed. Bresnahan (1981) provides an elegant framework for thinking about this issue in the context of our problem here. Most oligopoly models can be phrased in terms of a conjectural variations model (see, e.g., Friedman, 19xx). Bresnahan imposes the additional constraint that any conjectures held in the market are consistent, in the sense that the eventual equilibrium fulfills the conjectures. Then, depending on the nature of the cost curve of the firm, markets can evolve (for example) into either Cournot or Bertrand equilibria. In the extreme case of constant-cost production models, two firms suffices to achieve complete competition, where in cases with upward sloping cost curves of the firm, more standard oligopoly pricing emerges naturally from the model.

This work focuses our attention appropriately on the nature of the cost curves of the firm as an indicator not only of the pricing models that Bresnahan studied, but also when we might expect NFP firms to emerge to bypass monopoly behavior.

\textsuperscript{3} Kenneth Arrow (AER, 1962) argued that NFP organizations existed to create trust in the crucial situation of life and death matters that hospitals sometimes involve themselves in, but
why other service sector firms such as law and accounting offices are organized as for-profit partnerships rather than NFP organizations – the optimal scale may be sufficiently small to allow competition even in relatively small communities. (These are also services that can be carried out easier by mail and telephone than in person; health services, by contrast, have a requisite personal participation that requires a direct interface between the provider and the customer.)

Having made these generalizations, we can now turn to the task of specifying the quality choice and output/pricing decisions of NFP and FP firms.

III. The Determination of Price and Quality in FP and NFP Firms

A. For Profit Firms

The determination of optimal price and quantity in a monopoly remains a first year exercise in micro-economics. Figure 1 serves as a basis for building subsequent discussion. Figure 1 shows the problem for the monopolist at two qualities, \(D_1\) (at lower quality) with a corresponding marginal revenue (\(MR_1\)) curve and corresponding marginal cost curve (\(MC_1\)). Optimization at \(QL_1\) occur, of course, where \(MC_1\) intersects \(MR_1\) at the optimal quantity (\(q_1\)) and the firm selects the profit maximizing price to clear the market at \(p_1\). Profits are the usual area lying between the price \(p_1\) and the MC curve, from quantities zero to \(q_1\). A higher demand curve \(D_2\) is associated with a higher quality of output, with associated \(MC_2\), \(MR_2\), \(q_2\), and \(q_2\) choices.

In Figure 1, the demand curve shifts up less for the quality increment than does the MC of production of the higher quality, so profits are lower at the higher quality. It is obviously possible to draw a similar figure where the MC and D curves shift in such a way so that profits are higher at the higher quality. Indeed, the whole point of this exercise is that the FP firm must select the profit maximizing quality as well as price and output, although this choice is generally suppressed in normal discussions of the theory of the firm.

Figure 1 here — Profit Maximizing Choices with Two Qualities of Product

Thus, as Figure 1 shows, profits vary with both quantity and quality of output, and a profit maximizing monopolist will seek the optimum in both dimensions. The familiar inverted U shaped curve plotting profits against quantity of output can now be seen as a planar section of a three dimensional profit hill on which profits vary with both quality and quantity. So long as the production side eventually shows increasing MC for increasing quality, and the demand curve shows decreasing incremental shifts in Willingness to Pay (WTP) reflecting satiation in quality, then the profit function for the firm has a maximum value at some optimal quality, and the firm’s quality

this argument fails to distinguish between the existence of NFP hospitals and for profit doctor offices and for profit pharmacies.
choice is then determined. The profit-maximizing firm has a determinant output, quality, and price, all determined by demand conditions and production costs at different qualities of product. Figure 2 shows the profit hill characterizing the FP firm’s choice set, with optimal profits found as indicated on the Figure.

Figure 2 — Profit Maximization with Quantity and Quality Variable

B. Not for Profit Firms

A monopolist facing the same demand curves but organized as a not for profit organization will come to different choices on all dimensions. The essential legal fact is that the NFP firm has no shareholders to whom it may distribute profits, so for any quantity of output, it must select a price that clears the market on the demand curve in a way that produces zero profits. Points where the demand curve intersects the AC curve provide the relevant choices. In the general case with a U-shaped AC curve the demand curve will likely intersect the AC curve at two points, and (as we see below) the lower right hand of these is always the relevant choice.

The set of such equilibrium points traces out a feasible set for the monopolist-NFP firm in a way that corresponds to the choices of the FP monopolist, but obviously with different prices at each output level. For any quality, the FP monopolist charges a higher price than the NFP monopolist.

To determine the quality chosen by the NFP firm, we must introduce a preference function on the part of the firm. Following Newhouse (1970), I specify a preference function $U(QL, QN)$ where $QL$ and $QN$ are both “normal” goods to the monopolistic NFP firm. This simply says that, other things equal, the NFP firm would prefer to produce more rather than less, and that it prefers higher to lower quality. The nature of the tradeoffs between $QL$ and $QN$ provide the usual indifference curves for the firm, and the opportunity set determines what is feasible within the market and legal constraints. (A subsequent section discusses how these preferences are formed, and the role of donations and donors in forming these preferences.)

The NFP firm is constrained legally to produce at the zero-profit contour in the long run equilibrium, since it cannot disperse profits to shareholders and cannot accumulate them indefinitely. Thus, profits are intrinsically spent within the firm on more output and higher quality. Except under very unusual production and demand circumstances the NFP firm will produce more output than the monopolist, sell at a lower price, and produce at a higher quality of output.

Figure 3 here — NFP Monopolist Output Choice

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4 I should point out here that this is a potentially controversial statement: normally we say that organizations do not have preferences, but people do. I am stating here that the NFP firm acts as if it has preferences. Section IV discusses how these preferences arise from those of the members of the Board of Trustees.
To see this, consider the particular choice of QL and QN available to the NFP firm. The operating point will be determined in the usual utility-maximizing framework, with a set of indifference curves laid out along the zero-profit plane characterizing the preferences of the NFP firm. No matter what the tangency point chosen, so long as some simple regularity conditions hold, the quality and quantity chosen by the NFP organization will exceed that of the FP monopolist. Figure 3 shows the same profit hill projected to a single plane, and the highest-attainable indifference curve at the zero profit contour.

One can summarize the choices available to a NFP firm by characterizing the set of feasible choices that (a) produce zero equilibrium profits and (b) clear the market, given consumer’s WTP for various qualities of output. Figure 4 summarizes these choices, building from the two demand curves shown in Figure 1, and extending (by analogy) the set of other possible choices of quality. In general, the zero profit constraint is met whenever the demand curve crosses the average cost curve for a given quality. Since the NFP firm is said to prefer more output to less (for a given quality), only the lower-right of any two possible intersections is relevant. The equilibrium choice set, labeled EE in Figure 4, shows all possible combinations of quality, quantity, and price that meet these conditions.

These figures together demonstrate a fundamental characteristic about NFP firms: if set up in lieu of a FP firm, they will select higher output and higher quality than would a FP monopolist in the same market (as Figure 3 shows) and they will set a lower price in order to clear the market and fulfill the zero-profit constraint (as Figure 1 shows). Since they will select a higher quality output, they will also have higher average and marginal costs than a for-profit firm in the same “sector” of the economy, even if they produce efficiently. (Some discussions of NFP firms suggest that they produce inefficiently for a variety of reasons, some of which enter the discussion in Section IV.)

C. Monopolistic Competition

I next turn to the question of how these models function in a market with more than one competitor (as is common in many industries with NFP participants). Indeed, one of the interesting questions focuses on those occasions where NFP and FP firms compete directly with one another (as in the market for nursing homes, or blood supply, until legal changes drove FP firms from the market), other settings where only FP firms exist (as in manufacturing industries) and others where either NFP firms dominate (as in the US hospital industry) or where there are no FP suppliers (churches, higher education). In the for-profit world, entry takes place until excess profits have been exhausted, and opportunities are presumably exploited by entrants making decisions that include an understanding of the quality and price offered by competitors. (Indeed, the demand curves confronting an entrant are conditional on the quality and price pairs prevailing in the market.) The analysis of decision making by NFP firms in a monopolistically competitive environment in the previous section carry over directly from the monopoly analysis, except (as with FP competitors) the
demand curve confronting each NFP firm is conditional upon the price and quality of other market participants rather than being the set of market demand curves for different qualities.

Without providing a careful analysis at this point, I will conjecture that the distribution of quality between for profit and not for profit firms will show the same characteristics as in the monopoly world, namely that NFP firms will produce higher quality than FP firms. The simple logic here is that NFP firms will have a positive preference for higher quality (presuming the types of preference functions discussed previously), whereas in a monopolistically competitive world, FP firms should be essentially indifferent as to quality, since they have no opportunity for excess (monopoly) returns at any price-quality pair in equilibrium. Thus (I conjecture) the NFP firms will take the high-quality ground in any monopolistically competitive market, and FP firms will satisfy residual demand at lower qualities.

This approach now offers a basis for understanding when markets will be dominated by FP firms, or (conversely) by NFP firms, and when they will share the market. As noted before, the availability of virtually all qualities of manufactured goods (via storage and shipment) makes FP firms the dominant form in manufacturing sectors. In service sectors, the production technology will have something to say about NFP entry. First, if enough firms exist, then monopolistically competitive environments should lead to a wide array of qualities even among FP firms, so NFP firms may not be able to survive, save perhaps through tax advantages. Second, production technologies may allow easy offerings of different qualities of service. Banking would seem to be such a case, where many options of “preferred customer” status abound in commercial banking, and the firm can easily segregate lower and higher quality customers. Airlines do the same with first class and coach customers.

Tax status of providers may affect the equilibrium mix of NFP and FP firms, especially where they coexist in a market. Tax-exempt status (§501.c.3 of the Internal Revenue Code in the US) is automatically conferred on only a select group of firms (education, churches, charities), and others who use this tax exempt status must provide community service, the lack of which can be cause for revocation of the favorable tax status. Hospitals and nursing homes operate in this environment, for example. Note that NFP firms existed well before we had income taxes in the US, so while the tax structures may alter the mix of firms, we cannot insist that NFP firms exist only because of the tax subsidy.

Ultimately, in a mixed market, it would seem that NFP firms either exist because of the tax subsidy, or because economies of scale do not permit even one firm to exist at the high-quality level willing to be supported by donors. But another (and I believe) more powerful reason exists to show why NFP firms often coexist (often with multiple suppliers) with FP firms: The NFP firms early entry (when they had monopoly status), coupled with strong legal and organizational rules and incentives to keep NFP firms in business, may allow them to persist even if they would not have appeared in a market initially dominated by FP firms. The most important of these legal rules include the ability of NFP firms to accumulate endowments and the great difficulties in closing a NFP firm due to lack of tender offer mechanisms. For a useful discussion of issues of conversion of NPF to FP firms, see Marsteller, Bovbjerg, and Nichols, 1998.

The preceding sections have utilized the concept of a stable preference function for the institutions in question, without describing how those preferences arise, or whether or not they are stable. In this section, I develop a very simple model of NFP trustee voting to support the legitimacy of this basic idea, and as I discuss in the following section, the guarantee of stability is essential for the NFP firm’s survival in many cases.

In building up this story (I hesitate to call it a model at this point), I run rampant over a broad literature detailing complexities of such models and numerous occasions when in fact stability cannot be assumed unless some particular institutional feature sustains that stability. (Arrow’s voting paradox is perhaps historically the most famous of these types of problems.) The development that follows uses an extremely simplified world where a majority rule vote of Trustees occurs on all matters, and where only two dimensions of choice exist (QL and QN of output of the organization), and where both QL and QN can vary continuously. Each of these can obviously be challenged in terms of their reality, and each generalization away from these simple beginnings complicates the problem and introduces the risk of instability of preferences or may even question whether a preference function can be posited. My only goal here is to suggest how such institutional preferences can be formed, and to provide some basis for believing that they are stable over time. In general, I will show that many apparent changes in institutional preferences are in fact due to changes in the budget constraint. The production possibilities frontier (FF) used in this discussion contains the same information as the equilibrium production set EE in Figure 4, and is indeed the relevant portion of the zero-profit contour also shown in Figure 3.

A. A Three-Member Board — No Gifts

Begin with a Board of three members and a majority voting rule, arrayed by alphabetic nomenclature from A to C in terms of their preferences for higher QL. In this world, in effect, votes take place on who’s preferences will “count” as those of the institution. The most simple outcome prevails in this setting: the median voter wins and hence B’s preferences dominate decisions. Neither A nor C can mount an effective counter to B’s preferences, because any shift away from B’s choices harms either A or C relative to maintaining the status quo represented by the tangency of B’s highest-possible indifference curve with the possibilities frontier FF. Figure 5 represents these preferences.

Figure 5 here --3 Person Board; No Gifts

Consider first the issue of succession: At some point, each member of the BOT must leave office, either because of bylaw rules limiting terms of office or by incapacity or death. Almost all NFP corporations have BOT membership that staggers terms of office so that only a fraction of the existing Board is replaced in any year, typically 1/N of the Board’s membership where N is the paradigmatic term of office.

If either A or C are up for election, the natural consequence is to have them replaced by somebody else appropriately situated to the extreme of B. For example, A prefers a replacement to
the QL side of B, and C prefers a replacement to the QN side of B. A will surely never vote for somebody to the QN side of B. And B’s interests in control require that when A (or C) departs, the replacement sits to A’s (C’s) side of B on the preference ordering, thus preserving B’s status as the median voter. B’s only concern is to make certain that A’s replacement does not leapfrog over to the central position, and hence B will accept any candidate A nominates who is “A-like” in preferences. Exactly the same holds when C’s term of office is up. B will vote to replace C with a very C-like C’. This preserves the stability of the institution’s preferences (B’s) through turnover of either A or C.

If B’s term of office ends, then B’s obvious interests are to replace himself with somebody who has preferences as nearly identical to his own as possible. And neither A nor C have any interest or ability in any other outcome, since A would be made worse off if B’ moved in C’s direction, and visa versa. So, subject to B’s abilities to determine the preferences of his successor, B replaces himself with a virtually identical proxy board member, and the institution’s preferences remain stable even through the replacement of the median voter B.

**Gift Giving Incentives**

Before we can discuss the potential of gift giving to influence institutional behavior, we must consider the preferences and incentives confronting BOT members in terms of their giving. To make giving rational, we must either include in each Trustee’s preference function the well being of the institution (as measured by its preference function, namely, U(B) or else that the BOT member has QL and QN arising at the NFP institution as direct elements of the Trustee’s preference function. For a variety of reasons, the best approach posits a utility function for trustees of the generic form $U_i(X_i, QL, QN)$ where $i = A, \ldots, C$ and X indicates lifetime personal consumption of individual i. The most obvious reason for this is the ease with which this preference function converts to the institutional preferences shown in Figure 5 and those that follow. In each case, these all hold constant a variety of exogenous factors that would influence individual i’s giving to the institution. Indeed, these figures imply that the donor has reached a steady-state gift level that is already embedded in the FF function of the NFP organization, and the preferences shown assume that degree of giving.

A variety of events could change individual i’s giving preferences. First, exogenous changes in the person’s wealth, such as inheritances, permanent shifts in asset wealth (such as improved market value of tradeable assets) or changes in tax law might induce shifts in giving patterns. Changes in tax law that unambiguously reduced the individual’s tax burden would create a shift in giving arising from the pure wealth effect. (Increases in the tax burden might cause regret for previous gifts, but since the gifts cannot be retrieved, such changes have a one-way valve aspect to them.) Other tax changes might increase or decrease the marginal costs of giving to charitable organizations, creating both an income and a substitution effect. Because of substitution effects, even some increases in tax burden might increase charitable giving, and conversely, some types of reductions in tax burden might decrease giving. (These will ultimately depend on the income and price elasticity of demand for consumption of X by individual i.)

Even changes in the NFP institution itself might alter the propensity of any individual to give to it, either in restricted or unrestricted form. For example, a major donor might insist on changes in the top administrative leadership of the NFP organization before conferring a gift, if the trustee had no confidence in the current leadership.

And — to be clear — in many cases the election of a new member of the BOT occurs in
anticipation of giving, rather than with an actual gift at the time of election. Indeed, almost all NFP organizations allow for repeated terms of office for trustees, with re-election more likely to occur when the promise of giving (or other productive work for the BOT and the NFP institution) is fulfilled at least in part in the first term of office.

In any event, trustee giving can generally be presumed as stable (and hence the FF function stable) absent any unanticipated changes in trustees’ wealth and/or tax law. But if either of these changes in a way to increase the giving interests of any member of the BOT, then the prospect of new gifts must enter our analysis of institutional behavior.

**Institutional Behavior with Stable Preferences and Restricted Gifts**

A class of events can arise in the NFP organization that makes it appear as if preferences of the institution have changed, when in fact they have not. An important mechanism for this to occur is also a common one in the world of NFP organizations — the restricted gift. Restricted gifts arise when the donor promises to give $G to the NFP firm, but restricts their use in a way that the behavior of the institution changes. Consider, for example, a gift from C (or his supporters) specifying that the gift requires an increase in the QL dimension from QL* to QL**. Such gifts are legally binding (so long as the donor can enforce the restrictions) since the gift can be withdrawn if the conditions imposed at the time of the gift are violated. In the example shown in Figure 6, the gift expands the opportunity frontier up for all QL > QL**. So long as the fit is sufficiently large (a point addressed next) then B’s utility is improved, and B and C together will vote to accept the gift. It may improve, leave unchanged, or degrade A’s utility, but the coalition of B and C suffices to guarantee its acceptance (and hence agreement with the conditions imposed with the gift). While it appears as if the institution’s preferences have shifted, in fact it is the budget constraint FF that shifts, not the preferences. B was and remains the median voter, and his preferences continue to portray the institution’s. Exactly symmetric changes can occur with a gift from A (or her supporters) that would increase the equilibrium quality (and alter the opportunity frontier FF in analogous fashion. A before, the behavior of the institution shifts with the gift, and again, B remains the median voter.

**Figure 6 here — 3 Member Board; Restricted Gift Shifts Feasible Set FF to F’F’**

*Determining the Necessary Size of Gift.*

Next, consider how large a gift (say) C must make to alter the institution’s behavior in a preferred direction. A lower bound of the magnitude of the gift is determined by B’s preferences, since B will never vote to accept a restricted gift that reduces his utility from B1. Thus C confronts a problem in trading off the magnitude of gift with the extent to which QN can shift from QN* to some larger value. The further the shift (moving along B’s original indifference curve), the larger the necessary gift. Thus C’s incremental utility for X, QL, and QN determine the optimal offer from C.

**Buying the Median**

Can C or A ever buy their way into the powerful position of median voter? The mechanism, of course, requires (say) that C provide a gift of sufficient magnitude that B is assured of improved
personal utility even when relinquishing the median voter position to C. If a gift can be constructed that falls within C’s preferences and capabilities (assuming an increased wealth or related changes in personal circumstances) and simultaneously meets B’s goals of increased personal utility. If a gift of sufficiently large magnitude can be found, B will concur with C either to replace A with a new BOT member with preferences to the QL side of C (thus making C the median voter) or else B will agree to have himself replaced similarly.

Either replacement vote requires a credible permanent commitment of the institution to a path desirable to B. But even a restricted gift does not assure the credibility to B. For example, if C proposes a restricted gift (with a minimum level of QL guaranteed) in exchange for B’s departure from the Board, then once C is the median voter, he can propose to shift the gift from a restricted to unrestricted category (or change the restrictions to favor QN at the expense of QL) and — as donor — can agree to the shift in use of the gift. Thus C has no credible commitment to QL min once B abdicates the median voter position.

Similarly, if C proposes a wholly unrestricted gift (which simply shifts the FF frontier outward), then with a coalition of C and D (B’s or A’s replacement), that gift can be restricted (again, with C’s consent as donor) to amplify QN and reduce QL. Thus, C has no credible gifts to buy the median voter position on the BOT unless they guarantee B’s utility increases no matter what subsequent steps C and D take to redirect the funds (through restriction or re-restriction). Such a gift exists, of course, simply requiring that the FF frontier be shifted out to such an extent that no matter where one operates on that new frontier, B’s utility is no lower than the status quo. Only in such circumstances will C (or A) be able to buy the median from B.

V. Incentives Against Change

To the extent that NFP firms rely on gifts, the NFP organization has several important structural aspects that not only encourage giving, but (I believe) are essential to induce giving. The first is that no shareholders exist, to which gifts would surely be dispersed in a FP environment, thereby eliminating the benefit the donor had hoped to achieve. While it might be possible to fashion contracts with FP firms to accomplish specific goals (altering the behavior of the organization), enforcement and monitoring problems make this a very clumsy and inefficient choice for prospective donors. Second, of course, the tax deductibility of gifts (in the US and some other countries) gives the NFP firm a separate advantage over the FP firm. However, the two key features of the NFP form from a donor’s point of view involve the inherent behavioral stability of the NFP firm: It is designed to inhibit change, so that the donor is assured that the purposes to which his gift is put will persist, not only in function, but in the setting in which the activity is carried out.

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5 The extent to which gifts (either current or future) are tied to particular aspects of organizational behavior is perhaps well-exemplified by the statement of Steve Forbes (Presidential candidate in 1996 and 2000 elections), multibillionaire, and trustee of Princeton University. Forbes recently declared that he would give no money to Princeton so long as a particular individual (Peter Singer, DeCamp Professor of Bioethics in Princeton’s Center for Human Values, a center founded in 1990 “through a generous gift from Laurance S. Rockefeller, ’32) remained a tenured member of the Princeton faculty.
The NFP firm has evolved as an attractive vessel for donors because such firms have developed credible promises that they will not change. The two most important structural features (generic to all NFP firms) are (a) the lack of a tender-offer or similar market takeover mechanism, and (b) the self-replicating nature of the Board. As Section IV developed, the mechanisms by which Boards of Trustees of NFP firms evolve over time assures that any change in organizational purposes that might occur must come either very slowly (if at all), or else they come with such large gifts that the original donors’ purposes are likely to be improved, even if the organization changes its focus importantly.

Many people describe universities as hotbeds of radicalism, perhaps with an eye to Berkeley in the 1960s, and the perennial student riots in Paris, China, and elsewhere. However, in most cases, the radicalism (if it exists) is directed to society as a whole, not to the university’s functioning, and indeed, my own experiences and those of my fellow chief academic officers around the country attest to the belief that universities are in fact incredibly conservative. The ambiguity in property rights inherent in the NFP firm reinforces this behavior. Universities are aptly described as “The Land of 1000 Vetoes.” Every constituency — faculty, students, alumni, administrators, and trustees — all believe that they have important decision rights in universities. And each of those groups in fact represent multiple separate constituencies. For example, science and humanities faculties have little in common except shared concerns over benefits parking. Undergraduates, graduate students, and professional students all have very different goals and concerns. The interia created by these multiple constituencies often makes change in the University very difficult to achieve. Contrast, for example, the extended internal and external debate over the cessation of a few small doctoral programs within the University of Rochester over the past few years (almost all of which evoked international emails, and one of which led to professional-society committees and visitations from distinguished faculty committees from around the country) with the brief and almost invisible closure of Kodak’s Elmgrove facility (employing thousands of people) or Bausch and Lomb’s decision to sell what many viewed as its trademark product line — RayBan sunglasses.

Universities have a special mechanism to assure institutional inertia in addition to those generically present in NFP firms — unlimited tenure for faculty. Most observers of universities consider tenure as the result of a unionist-like faculty movement, entirely designed to protect faculty from vindictive administrators, and presented as an essential ingredient in the ability of faculty to preserve their ability to express ideas freely.\(^6\) However, in the context of attracting donors to the

\(^6\) I cannot accept this logic personally, since it is fundamentally flawed. Tenure processes may protect divergent thinkers once tenure is granted, but it necessarily serves the opposite goal for those who have not yet been granted tenure. The essential ingredient in achieving tenure at all US universities is the recommendation of those within the field of the tenure candidate that the candidate works well within the disciplinary paradigm. Radical thinking is often poorly tolerated in such a setting, and certainly attacking the work of the field’s established figures almost guarantees failure in the tenure process. The entire structure of intellectual paradigms (Kuhn, 19xx) works against intellectual radicalism, and the ultimate validity or invalidity of the work often has little bearing on its initial acceptance. Consider, for example, whether Galileo could receive tenure in a modern Physics Department where the conventional cosmological view was the received wisdom from Aristotle (earth-centered universe) rather than the view Galileo espoused and presented crucial evidence in support
university, one must also observe that tenure adds to the organizational stability and inertia, and as such, probably enhances the ability of the organization to attract donors. This is not to say that tenure is necessarily a good idea on net, but rather that it has positive aspects seldom (if every) recognized by university trustees and administrators.

(Copernicus’ heliocentric view). A similar story can be found in almost every discipline (Kuhn, 19xx), almost certainly including economics.
Figure 3

Figure 4