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The Pitfalls of Profits

**Why nonprofits should get out of commercial ventures.
At the same time, the tax code needs to be changed
to help nonprofits get more charitable donations**

By Burton A. Weisbrod

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or more than 150 years, the Young Men's Christian Association has helped Americans stay in shape. The association's Boston affiliate opened the first gym in the country in 1851. Forty years later, a YMCA physical fitness instructor in Springfield, Mass., James Naismith, invented basketball so his young charges would have a game to play indoors during the winter. In 1895, another Y instructor, who considered basketball too strenuous for older members, came up with the game of volleyball.

Since the 19th century, the YMCA has morphed into a health-and-fitness goliath. In 2001, this tax-exempt organization had revenues of \$4.1 billion, making it the largest nonprofit, in terms of earned income, in the United States. Today,

PHOTOGRAPH BY MASTERFILE





many of the more than 2,400 local Y's in the country boast basketball courts, swimming pools, jogging tracks, and well-equipped weight rooms.

These familiar neighborhood institutions are under heavy fire, however, for an increasing presence in upscale areas. Private health clubs, like Bally's, have sued Y's for unfair competition, claiming that as a tax-exempt charity, the YMCA is able to undercut private operators' prices enough to siphon away a significant amount of profitable business. "The feeling is that it's an uneven playing ground," said Brooke MacInnes, spokeswoman for the International Health, Racquet, and Sportsclub Association, a trade group. "We're talking about multimillion-dollar facilities with the best of equipment, the best of programs." Critics say that Y's are abandoning their traditional

pany would provide because they would be unprofitable. Because for-profit gyms could not make money by providing high-quality exercise facilities in inner cities and because providing such a service is socially valuable, in theory society subsidizes nonprofit Y's to open gyms in those areas.

The Y's expansion into new markets is just one example of how nonprofits are becoming increasingly commercialized. By commercialized, I mean the degree to which nonprofits rely on revenues other than donations or grants. (A "pure" nonprofit is one that depends entirely on contributions, gifts, or grants from private individuals, foundations, or governments.) The commercial activities of nonprofits span the gamut from charging user fees to forging marketing relationships with for-profits to generating revenues from businesses unrelated to the non-

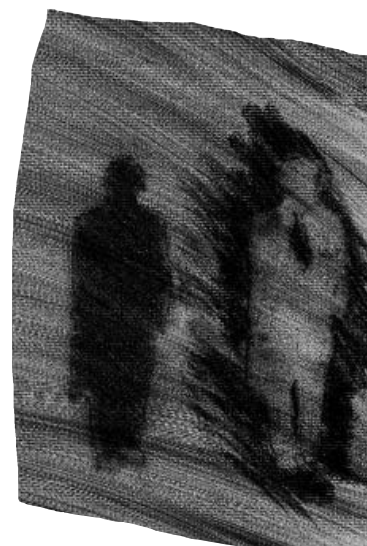
“THE FEELING IS THAT IT’S AN uneven playing ground. We’re talking about multimillion-dollar facilities with the best of equipment, the best of programs.”

mission of serving low-income neighborhoods. The Y counters that its mission is to serve people of all income levels, not just the poor, and that its upscale affiliates often subsidize memberships for low-income families.¹

The Y's expansion into affluent neighborhoods raises the question of whether it has become overly commercialized and whether it deserves its tax-exempt status. The rationale behind tax breaks for nonprofits is that nonprofits render goods and services that are valuable for society, ones that no for-profit com-

profit's mission. While these commercial activities do not necessarily produce conflicts with a nonprofit's mission, the danger is omnipresent.

The Y's expansion into affluent neighborhoods, for instance, may be generating revenue in the long run while simultaneously directing its money and commitment away from upgrading existing facilities in inner cities in the short run. Although the right balance between generating appropriate revenues and becoming commercialized may be a matter for debate, taxpayers and public policymakers should be concerned. In general, because of the various legal and reputational risks involved, nonprofits should avoid commercial activities – whether they be joint ventures with for-profit companies, unrelated businesses that subsidize the nonprofit's core activities, or other revenue-maximizing behaviors – that distract them from providing public goods at unprofitable rates. To make up the revenue shortfall, I believe that the tax code should be mod-



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Empty Treasury

Although unrelated business activities by nonprofits tripled over the past decade, they generated relatively little tax revenue. Nonprofits engaged in an unrelated business generally allocate so much of their “joint” costs – those not separately attributable to either their mission activities or their profit-making arms – to the taxable activities that they eliminate most of their tax liability.¹ Indeed, half or more of all nonprofit organizations that report unrelated business activity claimed no profit, and most reported a loss. One study estimated that by charging joint costs against taxable income, nonprofits annually report to the IRS from \$500 million to \$2.3 billion more in total expenses than they actually incur in their commercial activities.² There’s nothing necessarily illegal about such write-offs, but they raise the question of whether the unrelated business income tax is useful, given the opportunities for avoiding it.

1 Weisbrod, B., ed., *To Profit or Not to Profit*, (Cambridge, U.K.; Cambridge University Press, 1998): 296.

2 Sinitsyn, M. and Weisbrod, B. “Nonprofit Organization Behavior in For-Profit Markets,” Department of Economics, Northwestern University, 2004.

ified to encourage more individual donations to charitable groups – while at the same time restricting forays into commercialism.

Growing Commercialization of Nonprofits

The social sector is witnessing a wave of commercialization among nonprofits. The trend is partially a response to a leveling off of government grants and contracts as well as the lack of growth in tax-deductible donations to charity – the traditional sources of funding for nonprofits. Charitable contributions have remained relatively constant at 1.8 percent to 2 percent of donors’ income for many years.

In response, nonprofits have turned toward commercial sources of revenue. For example, many nonprofits have begun charging user or admission fees. Until 1990, few museums or zoos charged such fees; today there are few that don’t. But charging fees to increase revenues has its limits and risks. An art museum, for example, risks losing at least part of its audience, particularly schoolchildren, when it imposes or hikes admission fees, although many museums temper their commercialism with free admission for school groups.

Nonprofits have also begun to seek revenues from marketing relationships. In 1997, the American Medical Association struck a deal with Sunbeam Products, the maker of small appliances, to endorse the firm’s heating pads and humidifiers. The nonprofit AMA hoped to earn millions of dollars by giving Sunbeam exclusive rights to use its well-known serpent-and-staff logo to promote products.

Research and development partnerships with for-profits have come into vogue, especially among universities. In 1998, the University of California, Berkeley agreed to conduct biotech research under a \$25 million contract with Novartis, the Swiss pharmaceutical company. The deal was unusual in that it gave

the drug maker the right of first bid on research products from the university’s plant biology department – even those underwritten with federal funds – as well as seats on the department’s research review committee.

Joint purchasing partnerships between nonprofits and for-profits are also on the rise. Austin, Texas-based St. David’s Health Care System formed a partnership with the Columbia/HCA Healthcare Corp. in 1996. St. David’s executives believed that the Tennessee-based chain, now simply called HCA, could provide the buying power and

economies of scale that St. David’s needed to remain competitive in an uncertain financial climate.

Many nonprofits have taken an even more significant step toward commercialization: They are engaging in what the IRS deems “unrelated business activities.” In other words, they are providing and charging for services or goods that have little or nothing to do with their social mission. For instance, nonprofit hospitals are setting up cardiac fitness centers and opening retail pharmacies. Colleges and universities are booking “educational” tours and cruises. Some are even leasing laboratory facilities to private pharmaceutical firms. Nonprofit museums such as the Art Institute of Chicago have opened retail shops in shopping malls that directly compete with private firms like the Museum Company. The American Museum of Natural History in New York rents out its dinosaur display area for exercise classes.

Nonprofits also are entering joint ventures and other cooperative arrangements with for-profits. Witness San Diego State University’s agreement with the San Diego Padres to offer a new MBA program oriented to sports. Some nonprofits are even challenging the legal distinction between nonprofits and for-profits by creating wholly owned, for-profit subsidiaries to carry out commercial activities. For example, Cornell University recently formed a for-profit subsidiary, eCornell, to provide online learning programs. But this rush to pump up bank accounts exposes nonprofits to a host of risks.

A World of Minefields

At a minimum, nonprofits risk their good name when they forge partnerships with for-profits. Ethicists argued that the AMA’s deal with Sunbeam was inappropriate because it was unethical for a physician’s group dedicated to the public good to be paid to endorse commercial wares. The incident turned into a major

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debacle for the AMA. More than 2,700 members quit, costing the association more than \$1 million in dues. “It was a PR nightmare in that the media and the members, and ultimately the AMA, realized that we were doing something that we shouldn’t have been doing,” said an AMA spokesman.² The association’s chief executive and several other ranking officials lost their jobs. Sunbeam later sued for breach of contract, and the AMA wound up paying more than \$10 million to settle the case.

Similarly, while supporters of Berkeley’s contract with Novartis said it would bring the plant biology department much needed cash, give professors access to sophisticated equipment, and help the university win other research funding, critics said it could compromise the faculty’s independence and skew research priorities. In 2000, the *Atlantic Monthly* spotlighted the deal in an unflattering article headlined “The Kept University.” Last August, a team of scholars from Michigan State University, after a two-year review, concluded that universities should henceforth avoid such pacts, even though it could find no evidence that Berkeley’s research had been tainted. The MSU report also reported that internal turmoil over the arrangement had damaged faculty collegiality and had created a potential conflict of interest among administrators that affected the tenure review of an assistant professor who had vociferously criticized the deal.

Some nonprofits have lost tax-exemption status as a consequence of their commercial forays, like St. David’s Health Care System did in 2000. The controversy began when St. David’s formed its partnership with Columbia/HCA Health-care. After a two-year audit, the IRS ruled that by linking itself with a profit-making company without retaining clear

control, St. David’s had forfeited its nonprofit status and had to start paying taxes. St. David’s paid more than \$1.1 million in back taxes, interest, and penalties for 1996 alone. Although a jury eventually ruled to restore St. David’s nonprofit status, the lengthy legal struggle drained funds that the medical center had earmarked for Austin-area charities, such as clinics for the poor.

Lately, the suspicion that certain nonprofits are not upholding their end of the bargain by providing enough socially valuable goods has raised a stir in Washington. Allegations of nonprofit hospitals charging underinsured patients more than they charge patients enrolled in HMOs led U.S. Rep. Bill Thomas (R-Calif.), chairman of the House Ways and Means Committee, to hold hearings in June to determine whether medical centers are violating their duty to provide charitable care.³

In short, the drive for profit exposes nonprofits to the charge of losing sight of their social goals. Devoting significant resources and staff time to beefing up a bank account may compromise the nonprofit’s ability to carry out its mission. Looking into the future, it is likely that “missions of nonprofits engaged in commercial activities will grow more ambiguous through time. New demands on senior management to pay attention not only to nonprofit but to for-profit goals, the adoption of new structures such as joint ventures that create mixed missions and messages for participating entities, and the tendency of senior management to look at activities from the perspective of their contribution to revenues may create an environment in which nonprofits must work especially hard to keep their charitable mission in daily focus. Increased responsibility will likely fall on boards of directors of commercial nonprofits to ensure that a

America’s Unique Generosity Toward Nonprofits

Nonprofits are exempt from federal income tax, and many local and state sales and property taxes. They are eligible for tax-deductible donations, and in some areas, they also receive municipal services free. Chicago, for instance, does not charge nonprofits for water. The United States is uniquely generous in giving these subsidies. No other nation grants subsidies at such a high level or across so

many types of activities. U.S. taxpayers in the highest marginal income tax bracket who itemize charitable donations, for instance, can save up to 40 percent of their contributions on their federal and state income tax returns. (No official estimate exists for the total value of nonprofits’ various tax exemptions, but charitable deductions alone are estimated to have cost the U.S. Treasury Department almost \$26 billion in 2000.¹ In addition, non-

profits are often exempted from financial restrictions placed on for-profit firms. For instance, the Sarbanes-Oxley Act of 2002, passed in the wake of accounting scandals at Enron and WorldCom, mandates greater disclosure of information by for-profit corporations, but not nonprofits.

1 Brody, E. “Charities in Tax Reform: Threats to Subsidies Overt and Covert,” *Tennessee Law Review* 66, no. 3 (1999): 694-97.



dilution of charitable mission does not occur. ...”⁴

The Importance of Being Nonprofit: What Taxpayers Get for Their Money

Can nonprofits perform their missions and also maximize revenues and minimize costs like private companies? An organization’s behavior, whether nonprofit, for-profit, or governmental, is at least in part determined by its sources of financial support. For example, if donations and government grants entirely supported the Y, it would probably not be expanding into affluent neighborhoods. There are advantages to nonprofits being “pure.” The nonprofit’s unique ability to address social goals is often predicated on its lack of profit-making motives and behaviors. There is considerable evidence that nonprofits tend to undertake unprofitable but socially beneficial activities, while for-profits restrict themselves to doing good in ways that rarely risk the bottom line. This is certainly the case in the healthcare industry.

My research and the research of others has shown that nonprofit healthcare providers often deliver more services, better service, and higher levels of patient satisfaction than for-profit providers, while simultaneously generating fewer complaints and regulatory violations. Nonprofit hemodialysis centers are a case in point. Patients with end-stage kidney disease may receive dialysis at either nonprofit or for-profit facilities, with the

federal government picking up the tab at both. A longer dialysis session is generally more effective at cleansing a patient’s blood, so the length of the session is a useful measure of the quality of care. Research has shown that sessions are generally longer – and mortality rates significantly lower – at nonprofit centers, even after adjusting for the severity of patients’ illness.⁵

Likewise, a study of 500 Wisconsin nursing homes found that nonprofit facilities trigger far fewer consumer complaints and regulatory violations than their commercial cousins. While we can’t rule out that consumers and regulators are less forgiving of the shortcomings of for-profit nursing homes, research also indicates that nonprofit facilities have significantly higher per-patient ratios of doctors, nurses, dieticians, maintenance workers, and volunteers than

do proprietary homes.⁶

Research has also shown important differences in the use of sedatives – which make caring for patients less expensive – at for-profit nursing homes versus church-run, nonprofit facilities. Although a 1984 study showed no significant difference in the severity of patients’ illnesses at the time of admission, it found that for-profit homes subsequently administered more than four times as many sedatives as church-operated homes.⁷ Studies also indicate that relatives of patients in nonprofit nursing homes, psychiatric hospitals, and facilities for the mentally handicapped report greater satisfaction with the treatment, staff, buildings and grounds, and social activities.⁸ Furthermore, new research on another industry – hospices – finds that for-profit facilities boost profit by attracting patients with longer life expectancies, thus increasing Medicare reimbursements and profits.⁹

There is evidence, however, that nonprofit hospitals deliver only slightly more uncompensated “charity care” than do for-profit institutions. The same is generally true of medical education and research, with nonprofit hospitals delivering only marginally more than for-profits. Nevertheless, nonprofit hospitals are more likely to provide other unprofitable but socially positive services. I recently examined the likelihood that nonprofit and for-profit hospitals would provide each of 80 specific medical services. I found that nonprofit and government-owned facilities were significantly more apt to deliver 19 crucial services,

The Difficulty of Determining What Distorts Mission

If it were entirely clear that certain commercial activities were in conflict with nonprofits' pursuit of their tax-exempt missions, the IRS would be revoking tax-exempt status far more often. What is more commonly observed, however, is ambiguity as to the effects – ambiguity that reflects the typically broad scope of mission. Thus, we have found that in light of such mission vagueness, it is understandable that nonprofits typically claim there is no conflict – that commercial sales activities are not simply generating money but are simultaneously advancing organization mission. The Girl Scouts, for example, hold that the sale of cookies is not merely a commercial activity to raise money, but an exercise through which young girls gain experience that helps build their character and impart business skills. ... We have seen repeatedly how broad goals make it difficult to determine whether a commercial activity that garners revenue brings any adverse side effect with regard to mission.¹

1 Weisbrod, B., ed. *To Profit or Not to Profit* (Cambridge, U.K.; Cambridge University Press, 1998): 289.

including emergency care, in-patient care for those with AIDS, and hospice care.¹⁰

Losing Their Souls?

Society has every right to demand evidence that nonprofits are producing sufficient social goods to justify their tax exemptions. But with government funding either decreasing or failing to grow as fast as the perceived “needs,” nonprofits must find alternate sources of revenue to finance their social missions. Can public policy encourage nonprofits to provide unprofitable but socially desirable outputs without also creating incentives to seek funds in ways that undermine the nonprofits' capacity to act in the public interest? There's no magic answer. But the pitfalls of commercial activity lead me to support a rebalancing of the tax code concerning sources of nonprofit revenue. Everyone would benefit from stronger tax incentives for donors to give relatively small, unrestricted

gifts to nonprofits coupled with attempts to reduce incentives for nonprofits to engage in commercial ventures. Two federal lawmakers are currently pushing legislation that moves in the direction of encouraging donations. Rep. Roy D. Blunt (R-Mo.) and Sen. Rick Santorum (R-Pa.) are trying to persuade fellow lawmakers to amend the tax code to permit people 70½ and older to transfer money directly from their individual retirement accounts (IRAs) to nonprofits without incurring income taxes and to allow taxpayers who do not itemize on their income tax returns to deduct some of their charitable gifts. Although these amendments to the tax code would provide an incentive to donate, they do not directly address the issue of nonprofits becoming involved in commercial activities.

Another mechanism worth exploring is granting limited tax credits to individual donors, rather than continuing the current reliance on tax deductions. The problem is that when the government lowers tax rates to stimulate the economy, the cuts have the unintended effect of reducing the incentives to donate. That is because the lower the taxpayer's rate, the greater the after-tax cost of donating a given sum. With tax credits, the after-tax cost of donating is the same for everyone, rather than being dependent on the donor's tax bracket. Moreover, changes in income tax rates would not alter the after-tax cost of giving. Of course, when policymakers wrestle over shifting from tax deductions to credits, restructuring incentives to reduce nonprofits' commercial activity, or changing other tax policies, the devil is in the details.

The problems with commercialism are often subtle. For instance, when a nonprofit emulates the behavior of a private firm, the lure of profits may change the incentives that shape managerial behavior. In recent studies of hundreds of hospitals, an industry in which for-profits and nonprofits compete, we found that increasing competition from other hospitals and HMOs is associated strongly with a shift away from fixed compensation toward bonus-based compensation for nonprofit CEOs, a practice historically more common in for-profit hospitals.¹¹ Bonuses need not be, but typically are, linked to easily measured financial indicators. On



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might expect that broader social goals that justify public subsidization would suffer as a result. To know whether this actually occurs will require further research.

Mechanisms to encourage donations, by altering tax law, are readily available. Mechanisms to discourage commercial activity, however, are more challenging. Outright prohibition of any activity that generates “sales” would have vast and uncertain consequences, but the use of tax instruments to discourage all commercial activity – not merely unrelated business activity, which is already subject to taxation – deserves exploration. We should also explore how a shift in

7 Weisbrod, B. *The Nonprofit Economy* (Cambridge, MA: Harvard University Press, 1988).

8 Weisbrod, B. *The Nonprofit Economy*.

9 Lindrooth, R. and Weisbrod, B. “Do Nonprofit and For-Profit Organizations Really Differ? The Hospice Industry,” unpublished working paper, Department of Economics, Northwestern University, and Medical College of South Carolina, 2004.

10 Weisbrod, B. “Why Private Firms, Governmental Agencies, and Nonprofit Organizations Behave Both Alike and Differently: Application to the Hospital Industry,” unpublished paper, Department of Economics, Northwestern University, 2004.

11 Erus, B. and Weisbrod, B. “Objective Functions and Compensation Structures in Nonprofit and For-Profit Organizations: Evidence from the ‘Mixed’ Hospital Industry,” in *The Governance of Not-for-Profit Organizations*, Edward L. Glaeser, ed. (Chicago: University of Chicago Press, 2003): 117-142.

THERE IS CONSIDERABLE EVIDENCE THAT NONPROFITS tend to undertake unprofitable but socially beneficial activities, while for-profits restrict themselves to doing good in ways that rarely risk the bottom line.

public policy that encourages donations rather than commercialism would affect the various industries in which nonprofits operate. For universities, user fees in the form of tuition are a major source of revenue, while user fees are of little import for soup kitchens. But as these issues are examined, we should not forget that nonprofits require some kind of funding for their social missions; it would be counterproductive to constrain commercial revenue-producing activity without also relaxing constraints on donations. Reshaping the pattern of nonprofits’ revenue should not be a pretext for constricting this valuable economic sector. □

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1 Stanford Social Innovation Review interview, October 2004.

2 Stanford Social Innovation Review interview, October 2004.

3 *The Hill*, March 10, 2004, p. 13.

4 Personal communication from Howard P. Tuckman to Burton Weisbrod, cited in Weisbrod, ed., *To Profit or Not to Profit*, (Cambridge, U.K.: Cambridge University Press, 1998.): 305.

5 Devereux, P.J. et al. “Comparison of Mortality Between Private For-Profit and Private Not-For-Profit Hemodialysis Centers,” *Journal of American Medical Association* 288, 19 (Nov. 20, 2002): 2449-2457.

6 Weisbrod, B. and Schlesinger, M. “Ownership and Regulation in Markets with Asymmetric Information: Theory and Empirical Applications to the Nursing Home Industry,” in *The Economics of Nonprofit Institutions: Studies in Structure and Policy*, eds. Estelle James and Susan Rose-Ackerman (New York: Oxford University Press, 1986.): 133-151.

