

## Chapter 3



### REVIEW CONCEPTS

- Asymmetric Information:** When the two parties to a market transaction know different things about the quality or quantity of an exchange such that the more-informed party can take advantage of the less-informed party.
- Benefit Corporation:** A type of hybrid organization legal in some states in the U.S. that relies on third-party certification to balance the organization's social and financial bottom lines.
- Collective Good:** A good or service that a group of people can simultaneously consume.
- Community Interest Company (CIC):** A type of hybrid organization used in the U.K. that limits the distribution of dividends to below-market rates and insures that assets dedicated to the social mission cannot be distributed upon organizational conversion or termination.
- Contract Failure:** A kind of market failure resulting from asymmetric information in which the buyer (donor) is unable to verify whether the promised quality or quantity of a good is delivered.
- Contracting Out:** When government pays private organizations (for-profit, nonprofit, or hybrid) to deliver a good or service.
- Excess Burden of a Tax:** A dollar measure of the efficiency lost when taxes distort economic behaviors.
- Excludable Collective Good:** A collective good with the property that one can exclude those who don't pay from enjoying that good. For example, an opera performance. Antonym: Nonexcludable Collective Good.
- Federated or Combined Fundraising:** When several nonprofit organizations coordinate and share their fundraising through a central mechanism such as United Way and agree to forgo or limit their individual fundraising efforts.
- For-profit-in-disguise:** An organization that distributes profits to owners while pretending to be a nonprofit organization.
- Low Profit Limited Liability Corporation (L3C):** A type of hybrid organization legal in some states in the U.S. that prioritizes charitable over profitmaking purposes.
- Market for Control:** A market where ownership of (usually stock-issuing) organizations is bought and sold.
- Price of Giving:** The amount of after-tax income that a donor has to give up to transfer \$1 to a charitable organization.
- Tax Credit:** A subtraction from the amount of taxes owed.
- Tax Deduction:** A subtraction from taxable income, that is, a subtraction before calculating taxes owed.

## EXERCISES

1. If nonprofits arise to fix problems of asymmetric information, why are there no nonprofit automobile repair shops? Speculate on possible answers.
2. Elizabeth Mauser (1998) found that those parents who placed their children in nonprofit day-care centers actually spent more time researching their choice than those who put their children in for-profit day care. Is this what contract failure would predict? Does this evidence persuade you that contract failure theory is incorrect?
3. For each of the situations described below, would you expect the nonprofit sector to be relatively large or relatively small, compared to the government and/or for-profit sectors? Explain.
  - (a) Preferences for public services differ substantially among local communities but are homogeneous within each local jurisdiction.
  - (b) A new city has rapidly growing needs for social services, and the average person only lives in the community for a couple of years before moving out.
  - (c) Property taxes are extremely high, but nonprofits are exempt.
4. A Taxing Problem: Suppose we were to eliminate the current tax deduction for personal donations and replace it with a matching grant system. At the end of each year, each nonprofit would mail an (audited) statement to the government indicating the total amount of personal donations they had received that year. The government would then mail a check to the nonprofit which matched donations by some fixed fraction. For example, if the matching rate were 30 percent, and a charity received \$100,000 in donations, the government would mail a check for \$30,000.
  - (a) This system is similar to a tax credit system in terms of the resulting effective “prices” for giving. Explain.
  - (b) There is at least one important difference between the effect of a tax credit and the effect of matching. Identify and explain the difference.  
(Hint: Who would be able to use the tax credit?)
  - (c) The matching grants would eliminate the pattern of “upside-down subsidy” in the current system of tax deductions. Explain why this is so and discuss whether this change is desirable.
5. Would you ever donate to a Benefit Corporation? To an L3C hybrid? To a CIC hybrid? How does the possibility of contract failure affect your answer?
6. In this chapter, we argued that the tax breaks given to nonprofit corporations lead to inefficiency. Does this mean we should get rid of these tax breaks? What are some pros and cons of doing so?