

**Donors, Ideologues, and Bureaucrats: The Principal-Agent Relationship  
between Government and the Nonprofit Sector**

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## **Introduction**

In profit-seeking firms, principal-agent problems frequently arise when firms are owned by one set of persons and managed by another. Costly information makes it impractical for owners to perfectly monitor the behavior of managers, whose interests deviate from those of the owners. In the nonprofit sector, the oversight of management is hampered not only by monitoring costs but more fundamentally by the absence of owners, due to the nondistribution constraint on the disposition of net revenue. With shareholders out of the picture, economists have contemplated the tensions between the interests of managers and donors. Rose-Ackerman (1982, 1987) models the conflict between donors and managers when service provision reflects an ideology and there is heterogeneity in preferences over possible ideologies.

In this paper, I consider the role of government as principal and the nonprofit sector as a set of agents from whom, collectively, the government wants to maximize service provision. Essentially, the role of government as stakeholder imposes a normative perspective from which to assess the manager-donor tug of war. I begin with Rose-Ackerman's notion of ideological donors and managers, and develop the idea of "warm glow" managers to parallel the well-established concept of donors with "warm-glow" motivation to give. In contrast to the warm-glow donor-manager of Barla and Pestieau (2005), warm glow producers in this paper bear formal similarity to the public choice literature's notion of bureaucratic managers. I construct a simple model in which it can be shown that ideological managers prefer firms that, from the government's point of view, are too small, and warm-glow bureaucrats prefer firms that are too large. I then propose that government policy towards nonprofits may affect the kind of manager attracted to

the sector, and by so doing affect the size of nonprofit firms in ways that are normatively important to the government's objective of service provision.

The paper is organized as follows. First, I address the objectives of government, donors, and nonprofit managers. Second, I present a model in which nonprofit service provision has two dimensions, service and ideology. I distinguish between two pure types of managers, ideologues and bureaucrats, and show how the first-best firm size differs from that preferred by managers. Next, drawing on the scholarship on government-nonprofit interactions of Smith and Lipsky (1993), I consider government policies that can affect the attractiveness of the nonprofit sector to managers who display varying degrees of ideological and bureaucratic tendencies. I close with some reflections on the implications of this model for future research.

### **What Government Wants from the Nonprofit Sector**

The admissible purposes for nonprofit firms set forth in IRS Section 501(c)(3) are charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition, and the prevention of cruelty to children or animals. All of these except testing for public safety are eligible to receive tax-exempt donations. Nonprofit firms incorporated under IRS Section 501(c)(4) address social welfare and may lobby government, an activity strictly limited in the case of 501(c)(3) firms; donations to 501(c)(4) organizations are not tax-deductible. There are two distinct governmental purposes served by a nonprofit sector constructed in this way. First, the sector safeguards certain basic liberties and freedoms, such as freedom of worship and freedom of expression. Second, the sector provides basic consumption goods, such as food, shelter, health care, and education, which are also provided by

government. While the design of a nonprofit sector devoted to protection of liberties may be little concerned with questions of economic efficiency—in John Rawls’ *Theory of Justice*, for example, liberties are lexically prior to economic considerations (Rawls 1971)—programs for nonprofit provision of goods that might also be produced by the government sector are naturally weighed in efficiency terms.

In this paper, I focus on the second general purpose of the nonprofit sector, that of the provision of basic consumption goods and services. There are a number of reasons for government to foster a nonprofit third sector that supplements for-profit and government provision of basic commodities. Weisbrod (1975) argues that democratic choice of governmental levels of provision will leave high-demand citizens unsatisfied, and their residual demand is addressed through nonprofit provision. Hansmann (1996) and others have argued that the nondistribution constraint encourages donations to nonprofits because, in the absence of transparency about how individual donations are used, for-profit firms would have an incentive to pass donations to shareholders rather than use them for service provision. A third reason is that nonprofits can provide goods in manners unavailable to the government, such as in a religious environment, and this latitude encourages donations from like-minded individuals.

In this paper, I consider the nonprofit provision of goods (such as feeding the poor in soup kitchens) that are not intrinsically off-limits to government (as is providing religious instruction) but which can be provided by nonprofits in an atmosphere (such as one of religious instruction) that is attractive to donors and proscribed to government. Rose-Ackerman (1987) has called this malleable dimension of service provision *ideology*, and I adopt that term here. The government finds it expedient to allow the

incorporation of nonprofit firms because (1) nonprofit status can be targeted to firms providing types of goods the government wants provided, (2) the nondistribution constraint encourages private funding by individuals willing to donate to nonprofits, and (3) donations are enhanced when donors' ideologies match those of the nonprofits they support.

This view of government as principal adds a relevant aside to the definition of ownership under which one concludes that nonprofit firms "have no owners." Viewing the firm as a nexus of contracts, owners are the persons who have (1) residual decision making authority and (2) claims to residual earnings. Because the nondistribution constraint imposed on nonprofits disallows any claims to residual earnings, nonprofit firms are not owned. It is interesting to note that government, while lacking both criteria for ownership, has broad authority to usurp discretionary decision making through its regulatory powers, just as it has power to deny residual earnings to other parties. So while government does not own the firm, it actively and with discretion limits the extents to which other stakeholders exercise the authority generally assigned to ownership.

### **What Donors Want from the Nonprofit Sector**

Three basic conceptions of donor orientation towards the nonprofit sector are altruism, warm glow, and ideology. Altruists care about the provision of a public good or service without reference to their own role in its provision; such models predict more free-riding than can be reconciled with widespread charitable giving (see for example Bergstrom et al. 198x). Impure altruists, or "warm glow" givers, care exclusively about their own role, getting satisfaction from the amount of their donation. Ideology has been described by Rose-Ackerman (1996):

Some people care about ideas as well as objects and people. Rather than simply wanting to “help others” or “support culture” in a generalized way, they have particular beliefs about the best way to do these things. They feel pleasure when an idea they support is reified in a service-providing or advocacy organization. (pp. 716-717)

The donors in this paper are warm-glow givers who get more satisfaction from their gifts when there is a good ideological match between their preferred ideology and that of the nonprofit they support.

### **What Managers Want from the Nonprofit Sector: Ideology versus Warm Glow**

Do altruism, warm glow, and ideology capture the behavior of nonprofit managers as well as donors? Although cooperation among firms is sometimes observed, managers of nonprofits are seldom modeled as acting altruistically, without reference to their own firm’s contribution of goods and services. Rather, nonprofit managers are likely to have specific ideas about how best to deliver services and hence to prefer their own service delivery to that of others. These preferences may be fueled by professional experience – managers may be well informed about the efficacy of alternative modes of service provision – or by the values of the community from which the nonprofit arises. Smith and Lipsky (1993) describe communities in ways that echo Rose-Ackerman’s description of ideology:

Communities are not only self-conscious collectivities of shared sentiment. They also take on activities that are consistent with those sentiments. They establish churches, radio stations, study groups, newspapers, community centers, block clubs, and other activities that allow them to inject their values into the society for the benefit of themselves, or others. ... [Community shows] itself in the activities people undertake to express those shared values. These activities include problem-solving service agencies that communities incorporate as nonprofit organizations: they are communities made manifest.” (pp. 23-24)

Rose-Ackerman (1987) provides an early example of how government can shape the nonprofit sector when donors and managers both care about ideology, establishing the result that an unrestricted government grant to a nonprofit will cause it to cut back on its fundraising when donor ideology is at odds with the nonprofit's.

Having an ideological preference for one's own mode of service delivery meshes readily with a view of nonprofits as service maximizers. Lakdawalla and Philipson (2006) conceive of some nonprofit firms as "profit-deviators" with nonpecuniary motives. Specifically, the profit-deviating nonprofit firm's owner-donor-manager's utility is increasing in the firm's level of output. Such profit-deviating owner-donor-managers are in short supply; if the industry is large, there may be other nonprofit managers who are profit maximizers choosing to incorporate as a nonprofit for the tax advantages. Trade-offs between tax advantages and the disadvantage of the nondistribution constraint then determine the nonprofit share of an industry.

The notion of warm glow appears as a "joy of giving" that motivates the establishment of charitable firms in the work of Barla and Pestieau (2005), one of the few papers to address the question of whether the size of the nonprofit industry is optimal from the government's point of view. Because each nonprofit firm is financed by a single donor-manager and the only cost of the production of charity is the set-up cost associated with the establishment of the firm, these nonprofits might usefully be thought of as non-operating family foundations. As in Lakdawalla and Philipson (2006), the manager's utility is increasing in the level of firm output and the roles of donor and manager are collapsed into a single agent.

The Barla and Pestieau “joy of giving” formulation makes the point that “warm glow” can be ascribed to the behavior of nonprofit managers as well as to donors. Just as ideology can motivate both donors and managers, so can warm glow: a warm-glow donor gets satisfaction from the amount of his or her gift; a warm-glow manager gets satisfaction from the amount of service his or her firm provides. If “ideologue” captures the behavior of a manager who will sacrifice production for greater ideological control over the ancillary (from the government’s point of view) characteristics of service delivery, a “warm-glow manager” describes the behavior of a manager who will produce as much as budget constraints allow.

As noted by Steinberg (1987), an earlier model of the nonprofit manager as someone interested in the level of output is due to Niskanen (1971). Primarily interested in modeling the behavior of bureaucrats, Niskanen expresses the view that “A nonprofit institution, like the special case of a bureau, is assumed to maximize its budget subject to the constraint that the budget must be sufficient to cover the total costs of the service supplied—for the same reasons as in the bureaucratic environment.” (p. 81)

While decidedly lower in positive affect, “bureaucrat” describes the same objective function as does “warm-glow manager.”

This is the line of reasoning that leads to the central question mused over in this paper. If we believe in warm glow giving and in giving that is sensitive to ideology, we should consider warm glow production of services along with the ideological production of services. Warm glow management is formally equivalent to bureaucratic management. Government, having a stake in the size of nonprofit firms, is in a position to influence, through its powers to regulate, how bureaucratic the life of nonprofit managers must be.

By making the environment more bureaucratic, the nonprofit sector is likely to attract management that is less ideological and more bureaucratic. As we demonstrate below by looking at the extreme cases of management that is purely ideological and purely bureaucratic, shifts in the relative importance of ideological and bureaucratic rewards is predicted to affect firm size. Because purely ideologically driven firms are too small, the government has an incentive to bureaucratize the nonprofit sector. Because purely bureaucratic firms are too large, government has an incentive to allow competition and the entry of new firms.

### **The Model**

In the model presented here, the government's objective is to maximize the nonprofit provision of a service  $x$ . Nonprofit firms are funded by donations from donors who derive utility from the consumption of a composite good  $z$  and from making charitable donations  $d$  to the charitable provision of service  $x$ :

$$U = U(z, d(m)) .$$

Along with getting a warm glow from donating to the provision of  $x$ , donors have preferences over the ideology surrounding the good's provision. Ideology is measured along a single dimension of length  $L$ , and  $m$  is the distance between the donor's preferred ideology and the ideology of the nearest firm;  $d'(m) < 0$ . Service ideology is costlessly signaled to potential donors. Each donor contributes to at most one firm, choosing (if any) the one whose ideology most closely matches the donor's preferred ideology. Each donor's optimum donation  $d^*$  is an amount  $d_0$  when the firm's ideology is a perfect match, and donations are assumed to decline linearly with the extent of mismatch, until the donation goes to zero. Donors are spread evenly along the ideological spectrum and

the population size is such that the firm closest to the donors  $i$  who most prefer a particular ideology  $\ell$  receive donations from them given by

$$\sum_i d_i(m) = D - cm, \quad m \leq D/c,$$

$$\sum_i d_i(m) = 0, \quad m > D/c,$$

where  $m$  is the distance between the firm's ideology and  $\ell$ . It is assumed that the level of donor interest in the charitably provided good is high enough to support a positive level of service provision by at least one nonprofit firm.

This specification of charitable giving is purely warm glow; there is no potential donor concern over the "price" of giving that might lead donors to shun nonprofits that devote a large proportion of their budget to administrative costs rather than direct service provision. For reviews of the evidence on the extent to which donors take into account available information on the fraction of revenue devoted to overhead, see Brown and Slivinski (2006) and Bowman (2006).

Nonprofits are assumed to provide services with fixed costs  $F$  and constant marginal cost  $\gamma$ . The provision of services takes place in a costlessly produced atmosphere that reflects the firm's ideology. Each firm is run by a manager. Managing a firm offers two perquisites, control over ideology and control over resources. All managers care about at least one of these perks; this creates the tension between the aims of the government as principal and nonprofit managers as agents.

The two pure types of managers, caring exclusively about a single perquisite, are termed ideologues, in the spirit of Rose-Ackerman (1987, 1996), and bureaucrats, in the spirit of Niskanen (1971). Ideologues seek to minimize ideological dissent within the stakeholders of the firm; specifically, they prefer the narrowest possible donor base.

Bureaucrats, in contrast, want to manage the largest possible firm; they prefer the widest possible donor base.

Information on the ideological preferences of potential donors is assumed to be costlessly available to the manager, who in turn can costlessly solicit donations by truthfully signaling to donors the nonprofit's ideology. All donations are solicited; in this way, the nonprofit firm can limit its donor base.

The number of nonprofit firms in the industry is denoted  $n$ .

To see the government's principal-agent problem, consider the set of equilibria corresponding to (1) the first-best distribution of firms, (2) a distribution of firms along  $L$  with no gaps in the distribution (meaning that no donor's contribution is constrained at zero) and each firm of the size most preferred by managers who are ideologues, and (3) a distribution of firms along  $L$  with no gaps in the distribution of firms and each firm of the size most preferred by managers who are bureaucrats.

In the first-best case, the government chooses the optimal number of firms. As the number of firms increases, donations increase in response to a reduction in ideological mismatch, and production costs increase at a rate of fixed cost  $F$  per firm. The optimal number of firms trades off these costs and benefits in order to maximize total donations to the sector less costs, thereby maximizing the level of service provided by the sector.

To calculate total donations, observe that when there are  $n$  firms each firm occupies an interval of length  $(L/n)$  along the ideological spectrum. Choosing the ideology corresponding to the midpoint of this interval, the greatest mismatch is over a distance of  $(L/2n)$ . Donations decline linearly from a maximum amount  $D$  to  $D - (cL/2n)$ , yielding an average donation of  $D - (cL/4n)$ . Leaving no gaps between firms' donor

pools along the ideological spectrum, total donations are the product of the average donation and the length of the spectrum, i.e.  $DL - (cL^2/4n)$ .

The first-best problem therefore is

$$(1) \quad \max_n DL - (cL^2/4n) - Fn$$

which yields the first-order condition

$$(1a) \quad (cL^2/4n^2) - F = 0 .$$

It is convenient to measure the size of the firm in terms of  $(L/2n)$ , the distance of the marginal donor's preferred ideology from the ideology of the firm. The first order condition for the first-best distribution of firms yields

$$(1b) \quad (L/2n) = F^{1/2}c^{-1/2}$$

Managers who are ideologues, by contrast, seek the narrowest possible band of supporters. Since neither donors nor the government is attentive to the ratio of administrative overhead (fixed costs) to program expenditures, these firms will be small, barely covering their fixed costs. Total donations to the firm are its average donation  $D - (cL/4n)$  times the width of the interval from which it draws donations,  $(L/n)$ . The narrowest achievable donor base is found by setting

$$(2) \quad (DL/n) - (cL^2/4n^2) = F$$

Solving this quadratic equation for  $n$  yields half-width for the firm's donor base of

$$(2a) \quad (L/2n) = F/[D + (D^2 - Fc)^{1/2}]$$

That a sequence of firms of this size packed along the ideological spectrum yields a Nash equilibrium is obvious, since each manager in the industry has the most preferred firm

size and no manager outside the industry would want to enter because there is no way to enter and attract enough donations to sustain an additional firm.

Bureaucrats, on the other hand, want their firms to be as large as possible. If unconstrained, they will seek all donors willing to make positive donations. Donations fall to zero when

$$(3) \quad D - (cL/2n) = 0,$$

which implies a distance of

$$(3a) \quad (L/2n) = D/c$$

A sequence of firms of this size packed along the spectrum represents a Nash equilibrium if all managers are bureaucrats and there is no threat of entry by additional firms. The best option for entry is with an ideology halfway between the ideologies of existing firms; the new firm's donor base would be half as wide as the base of existing firms and its attractiveness to bureaucratic managers would depend on its viability as a firm and the available alternatives in the rest of the economy. I assume that the rest of the economy offers attractive alternatives and therefore, in the absence of potential entry, the bureaucratic solution of firms of half-width  $D/c$  is an equilibrium.

To confirm that the first-best firm size lies between those chosen in a world of ideologues and a world of bureaucrats, we note that the condition that the level of donor support in this industry be high enough to support a positive level of service provision by at least one nonprofit firm implies that total donations to a firm with a half-width of  $D/c$  (at which width all possible donations have been collected) exceed the firm's fixed cost  $F$ . Expressing total donations as the average donation times the width of the interval over which donations are collected, this gives

$$(4) \quad [D - c(D/2c)](2D/c) > F$$

or

$$(4a) \quad (D^2/c) > F .$$

To establish that the size of the bureaucratic firm expressed in (3a) is larger than the first-best firm expressed in (1b), note that by (4a) we have

$$D > F^{1/2}c^{1/2}$$

which implies

$$D/c > F^{1/2}c^{-1/2} \quad \text{Q.E.D.}$$

To establish that the size of the ideologue's firm given in (2a) is smaller than the first-best firm, note that (4a) implies that

$$D^2 - Fc > 0 \quad \text{and, as we saw above, } D > F^{1/2}c^{1/2}$$

Applying these inequalities in turn gives

$$F/[D + (D^2 - Fc)^{1/2}] < F/D < F/(F^{1/2}c^{1/2}) = F^{1/2}c^{-1/2} \quad \text{Q.E.D.}$$

Each of the pure models of ideologues and bureaucrats contains a large dose of caricature. Donor watchdog groups send up red flags if nonprofits allow overhead to eat up more than, say, a quarter of revenues (Bowman 2006); there are surely limits, both internal and external, that apply to the process of shrinking a firm in order to obtain ideological purity. Similarly, an equilibrium of large bureaucratic firms unthreatened by the entry of new firms overstates the power of large incumbents to forestall entry. It is worth noting, nonetheless, that there are clear differences in the predicted behavior of nonprofit industries dominated by the two types of firms (in other words, all that caricature buys us something in the way of predictive power). An important example is behavior in response to population growth, which I explore next.

*Population Growth and the Behaviors of First-Best, Ideological, and Bureaucratic Nonprofit Sectors*

One interesting question to ask of this model is what happens over time as the donor population grows. How does the first-best nonprofit industry change, and does this suggest that government policy towards nonprofits will shift over time? If so, is it in the government's interest to bureaucratize the sector over time or, alternatively, to encourage ideologically committed organizations?

To consider the behavior of the industry as population grows, let the level of donations be indexed to the size of the population by an index  $p$ . Donations to the ideologically closest firm from potential donors of a given ideology are given by  $p(D - cm)$ , where, as before,  $m$  is the extent of mismatch between donor and firm ideology and  $pD$  and  $pc$  are, respectively, the level of donation given no mismatch and the rate at which donations decrease with mismatch. For an initial index value  $p=1$ , this is identical to the situation modeled above.

Revisiting the conditions governing the first-best solution to the number of firms in the nonprofit industry and the ideological diversity within each firm's donor pool, we have

$$(5a) \quad (L/2n) = F^{1/2}(pc)^{-1/2}$$

as the optimal half-width for the firm's donor pool, which can be rewritten as

$$(5b) \quad n = \frac{1}{2} L(pc)^{1/2} F^{-1/2}$$

to give the optimum number of firms. By inspection, it is clear that as population  $p$  increases, the number of firms increases and the ideological diversity within firms

decreases. This is because population growth increases the loss from ideological mismatch; with more donors cutting back, it is in the government's interest to reduce mismatch by increasing the number of firms in the industry. Calculating the elasticities with respect to population of the number of firms and the width of the ideological spectrum of a firm's donor base shows that the number of firms grows at a rate less than the rate of population growth and the ideological base of the donor pool shrinks at a rate less than the rate of population growth. Because the number of firms is increasing, the size of the average donation is increasing. Since the population is increasing faster than the number of firms, this implies that the typical nonprofit firm in the first-best solution is growing, both by attracting more donors and by receiving a larger donation per donor.

In contrast, it can be shown that, as population grows, the number of firms in an industry of ideologues will grow faster than the rate of population growth. This is because a larger population at every ideology allows the firm to narrow its ideological base. The narrow base increases the average donation by reducing mismatch; hence donations, and the number of ideologically driven firms, increase faster than the population. Bureaucrats, on the other hand, would happily keep the same ideological base, in which case their donations would grow at the rate of population growth, the number of firms would not grow at all, and donations would rise at the rate of population growth.

A central prediction of this model is that the average donation will increase with the number of firms, as greater diversity allows for closer ideological matches between donors and firms. In the period 1992-1998, the number of nonprofit human services organizations increased by 37.2 percent. Over roughly the same period (1992 to 1997),

charitable donations to social and legal services organizations increased by 35 percent, from \$11.2 billion to \$15.1 billion (Weitzman et al. 2002); increases in population and per capita income would predict an increase of only 22 percent. The gross trends are therefore consistent with the view that the diversity of commitments in the nonprofit sector is important to donors and, therefore, important to government.

Should government be happy with this explosion in the number of nonprofits, or is the explosion a sign of ideologues running wild? In the period 1992-1998, expenditures in the nonprofit social and legal services sector grew by 64.9 percent (Weitzman et al. 2002), implying that average firm size, measured by expenditures, grew substantially, by about 20 percent. (Tucker and Sommerfeld (2006) present evidence that the size distribution of nonprofit social service firms, as measured by number of employees rather than expenditures, was fairly stable over this time period (see Table 8), but that social service organizations have been growing over a longer period.) With increases in population and income suggesting that a given ideological donor base's ability to contribute would have increased by about 22 percent, this is about the rate of growth of firm size that would have been predicted if the number of firms had not grown at all, that is, the rate of growth in firm size that we'd expect from a world of bureaucrats. In other words, the explosion in the number of nonprofits has not come at the expense of firm size; recent growth in nonprofit social services has been fueled by more than population growth and rising incomes.

It is not surprising that a model that focuses on donations will miss other factors that drive the overall size of the sector, Donations may be the extra revenue source brought to the provision of social services via the nonprofit sector, but they are far from

the only, or even the principal source of sector income. In 1997, for example, the \$15.1 billion in private donations received by nonprofit social and legal services organizations accounted for about 20 percent of the sector's total revenue (Weitzman et al. 2002). The fact that more than half of the sector's revenue (52 percent in 1997) comes from government suggests that government has discretion in shaping the nonprofit sector.

**Relevance for Government Policy towards the Nonprofit Sector: Lessons from *Nonprofits for Hire: The Welfare State in the Age of Contracting***

Given the government's involvement in the nonprofit sector, does it have policy tools that can shape the attractiveness of the sector for firms that care about both ideology and firm size? In their analysis of the "interpenetration" of the government and nonprofit sectors of the US economy, Smith and Lipsky (1993) make a number of observations that are relevant to the question of what government can do to affect the relative attractiveness of the nonprofit sector to ideologues versus bureaucrats. Although the central questions addressed in their work differ from those addressed here, it is worth noting that their views of government, the nonprofit sector, and their interrelatedness are largely consonant with the perspective I take in this paper. Regarding the principal-agent nature of the relationship between government and nonprofits, they see a key function of the nonprofit service sector to be to "supplement government provision" (p. 37) under circumstances in which "governments and voluntary organizations... operate on different internal values and often seek different objectives, but with respect to each other still act according to expectations generated by the contracting regime." (p. 43) Regarding the

goals of nonprofit managers, Smith and Lipsky see nonprofit management as seeking the financial security of size on the one hand and ideological commitment on the other:

A useful point of departure in the analysis of organizations generally is to think of them as oriented toward maintaining themselves and, where possible, making themselves stronger. Organizations therefore tend to seek out opportunities for growth... However, although the assertion that nonprofit organizations seek to secure their interests is a useful guide, other motives drive them as well. In particular, voluntary agencies are typically influenced by a strong sense of purpose and commitment. Thus nonprofit organizations are torn between organizational maintenance and pursuit of the purposive objectives.” (p. 149)

Finally, Smith and Lipsky assert that the government’s ability to shape the nonprofit sector has been underestimated. Referring to the nonprofit (or “voluntary”) sector’s inability to provide services at a level that would serve all needy citizens as “voluntary failure,” they write, “The theorists of voluntary failure, similarly, ignore the role of politics and the design of dominant political institutions as important factors in determining the nature of the voluntary sector.” (pp. 31-32)

Government can make the nonprofit sector more bureaucratic by protecting large existing firms from the entry of new nonprofits that would compete for their donor base (and, in the context focused on by Smith and Lipsky, for government contracts). The extreme case of a nonprofit sector consisting of non-overlapping bureaucratic firms may sound unfamiliar in contemporary America, but Smith and Lipsky point out that in some European countries, such as Germany and the Netherlands, “nonprofit agencies have almost monopoly status within their service jurisdiction. These agencies are reimbursed for their costs in accordance with prevailing laws which respect their autonomy.” (p. 110) In the U.S., they cite the prevalence of what economists term “regulatory capture:”

Nonprofit agencies are not above using government regulations of professional capacity to protect their share of the contract market.

Traditional agencies, which have the most to lose by the growth of the government-sponsored and new community agencies, sometimes make use of government standards to question the eligibility of the new organizations to receive or provide services. For example, in 1976 the traditional child welfare agencies in Massachusetts waged a successful fight to override a veto by Governor Michael Dukakis of a bill requiring that adoptions be handled by licensed child welfare agencies. ... Government regulations, in other words, do not always represent the agenda of government officials: they sometimes turn out to be the political agenda of influential nonprofit groups and individuals.” (pp 107-108)

Similarly, government policies tend to favor large existing nonprofits when they tolerate lobbying activities by the nonprofit sector. Political advocacy and lobbying are activities that advantage large and established incumbents, who can lobby for restrictions and standards that deter entry, and “use advocacy to their advantage by having their members sit on committees established by state agencies to investigate particular issues such as child abuse or homelessness, on boards of other agencies in the community, and on citizen oversight panels for public agencies. ... In contrast to the well-heeled agencies, the small nonprofits face great problems in affecting political institutions.” (pp. 176-177)

Other policies can affect how hospitable the nonprofit sector is for firms that hold ideological commitments. Financial support from government can come with strings attached; a common requirement is that nonprofits broaden the client base they serve: “[N]onprofit agencies often are less concerned than government to serve all clients within a specific target group; instead, nonprofits focus on serving clients compatible with the agency’s service mission.” (p. 123) Another fundamental challenge to ideologically committed nonprofits arises when the government supports nonprofits via contracts awarded competitively, giving nonprofits incentives to restructure their staffs and their operations in order to meet the criteria of the grant. Often this means a professionalization of the staffs of smaller nonprofits and a displacement of committed

volunteers from direct service delivery. Hiring staff with specialized degrees may increase the efficient scale of production as informal care, “characterized by a lack of task specialization” (p. 113), is replaced by the sort of specialization of labor that characterizes larger organizations that can fully utilize specialized personnel. Smith and Lipsky further observe that, when funding nonprofits through competitive contracts, government can support ideological commitments of firms by establishing performance-based standards rather than process-based standards that homogenize approaches to service delivery.

### **Concluding Remarks and Directions for Future Research**

Political scientists have appreciated that government policies shape the nonprofit sector. In this paper, taking into account potential donors who reward the alignment of their ideological commitments with those of nonprofit service providers, government is shown to have an economic stake in the extent to which it encourages small, ideologically committed nonprofits versus larger, more bureaucratic ones. Here, the cost of smallness is modeled in terms of the fixed costs of production; this effect would be amplified if we took into account government oversight costs, which also increase with the number of firms. These costs are traded off against the increase in overall donations that occurs when a greater number of firms allows a closer match to the preferred ideologies of donors. The optimal strategy for government changes over time, for example with population growth, when it is in the interest of government to encourage existing nonprofits to strengthen their ideological commitments, narrowing the ideological range of donors to whom they appeal, thereby encouraging the entry of new organizations. Conversely, an era of public skepticism about the performance of

nonprofit firms calls for a greater bureaucratization of the sector, as the government's per-firm costs of monitoring performance increase. A number of possible policies, as identified in the work of Smith and Lipsky, are available tools with which government can affect the relative balance between ideological commitment and a bureaucratic drive for bigness in the nonprofit sector.

There are several avenues for future research suggested by the work in this paper. First, the model in the paper might be developed more fully. The paper has not addressed the opportunities outside the nonprofit sector that determine how large a firm it takes to attract entry by bureaucratic managers, nor has it considered the possibility of the coexistence of different types of managers in the nonprofit sector. One formal extension of the ideas developed here is to model a continuous distribution of entrepreneurial styles defined as a convex combination of ideological and bureaucratic preferences. The government then optimally chooses a regulatory environment that is most preferred by the entrepreneurial type whose preferred firm size is the first-best size from the government's point of view.

The paper leaves to the reader's imagination the mechanism through which an ideologically diverse donor pool threatens the ideological control of ideologically committed management. Second, important instances of "ideology" concern best practices and standards of care; these are instances in which ideology is not produced costlessly. Nonprofits may wish to serve a particular clientele intensively, for example, whereas the government prefers that a broader base be served at a lower cost per capita. Third, a more general formulation of the distribution of donor preferences will have implications for the role of donors in the governance of the firm. In the model presented

here, with donors distributed evenly along the ideological spectrum, there is a coincidence within each nonprofit of the ideologies of the firm's manager, of the firm's median donor, and of the donor of the median dollar contributed. When the distribution of donors across ideologies is not uniform, these ideologies will in general diverge, raising interesting questions about the possibly destabilizing impact of donor-dominated boards on the distribution of nonprofit firms along the ideological spectrum.

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