Commercial Nonprofit Enterprises in the United States: The Phenomenon of Unfair Competition*

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Introduction

In the United States, nonprofit organizations enjoy special privileges granted by government which deliberately lower their costs of operation. When governmental funding of nonprofits began to decline in the late 1970s, many nonprofits sought alternative sources of revenue and began to enter commercial markets in competition with for-profit firms. Because of their special privileges, commercial nonprofit enterprises have a decided advantage over their for-profit counterparts, so that many for-profits have been driven from the marketplace or struggle to survive, and the formation of new firms has been discouraged. This article surveys the nonprofit sector in the United States and the privileges granted by government, discusses unfair competition and its economic consequences, and proposes a simple solution.

The Privileges of Nonprofits

In the United States, in addition to exemption from federal income taxes, nonprofits are often exempt from state and local income, sales, and property taxes. They receive special treatment from the federal government regarding unemployment insurance, minimum wages, securities, regulation, bankruptcy, antitrust restrictions, and copyright. The Federal Trade Commission has no jurisdiction over most nonprofits and there are numerous exemptions from state and local laws and regulations governing franchises, inspections, insurance, and bonding.

At all levels of government, contracts are often set aside for nonprofit organizations. Further, employees of nonprofits are treated differently under federal tax law than their counterparts in the private sector. Most

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nonprofits can receive contributions which are tax-deductible for the donor. Finally, nonprofits enjoy preferential postal rates that permit them to send mail at costs far below those paid by for-profits.

The special privileges given to nonprofits by government not only reduce operating costs, but also raise the costs of their for-profit competitors because profit-seeking firms must pay higher taxes and postal rates to offset the nonprofit subsidies. Thus, when a nonprofit organization uses its special privileges to compete with for-profits, it has a decided economic advantage.

Apart from the special economic advantages enjoyed by nonprofits, there is a bias toward nonprofit organizations in general, arising from their *pro bono publico* (for the good of the public) image. Although the halo of selfless charity surrounds nonprofit status, few private nonprofits are, in fact, "charitable" in the strict sense. Charities assist the poor, the handicapped, the unemployed, the hungry, the homeless, and the less fortunate in society, but only about 10 per cent of private nonprofits do that. Many organizations with "charitable" tax status serve primarily the wealthy and middle classes, operate institutions such as Harvard University or the Music Center of Los Angeles County, or exist to promote public awareness of issues. Labour unions, industry trade associations, museums, educational and religious institutions, performing arts, alumni and professional associations, credit unions, camps, hospitals, and nursing homes as well as other organizations can obtain nonprofit status.

In the United States, there is no explicit demarcation between nonprofits and charities. Strictly defined, the distinguishing feature of a nonprofit is that the organization's net earnings cannot be distributed to anyone who controls its operations, i.e., directors, trustees, and officers; any organization may obtain exemption from federal taxation if it is established for purposes that the United States Internal Revenue Code (usually section 501(c)) recognizes as exempt from taxation. Contributions are tax-deductible for donors to organizations granted tax-exempt status under sections 501(c)(3) and 501(c)(4), e.g., educational, scientific, religious, civic, social welfare, and other charitable organizations.

The Dimensions of the Nonprofit Sector

Estimates indicate that about 1.2 million nonprofits, including churches and their affiliates, are currently operating in the United States. Most have been established quite recently: two-thirds of the agencies in existence as of 1982 had been formed since 1960. Much of this growth was stimulated by the Great Society programs that heavily subsidized nonprofits. In 1982, nonprofits employed five times as many workers (including volunteers) as the domestic auto industry and accounted for one of every five service workers in the economy. Data from the U.S. Department of Commerce *Survey of Current Business* indicate that in 1985 all nonprofits spent $238.7 billion (roughly $1,000 per capita), compared to $83.6 billion in 1975. In constant 1972 dollars, the nonprofit sector spent $88 billion in 1985, a 31 per cent increase over the $67.6 billion spent in 1975. One 1987 study reported that "tax-exempt institutions are one of the fastest-growing segments of the economy, with annual revenues of more than $300 billion, about eight per cent of the gross national product. They're big employers too: in the Northeast, the 100 largest nonprofit firms employ more people than the region's 100 leading industrial companies". By any standard of comparison, the nonprofit sector is large and has been growing rapidly.

Unfair Competition

Beginning in the late 1970s, federal funding of Great Society programs began to taper off and nonprofits sought alternative sources of revenue. One source, commercial or "enterprise" activity, had begun to show promise over the preceding decade. A survey of nonprofit commercial activities conducted in 1983 revealed that "Sixty-nine per cent of the organizations [gave] ... birth to new enterprise within the past twelve years. Sixty per cent generate some of their revenues from enterprise activities".

Examples of commercial activities by nonprofits which compete directly with for-profit firms are abundant. The Smithsonian Institution, a museum which receives millions of tax dollars each year, sells household furnishings, clothing, jewelry, toys, posters, and myriad other items through 13 gift shops (which had revenues in excess of $27 million in 1986) and a mail order catalogue; conducts tours to 18 foreign countries and throughout the United States; publishes a governmentally-subsidized monthly magazine; and operates restaurants. YMCAs compete with private health clubs and fitness facilities.

Colleges and universities are aggressively commercial: they rent residence rooms during the summer; they rent and sell audiovisual materials and market computer software; their laboratories and scientific equipment—in many cases purchased, operated, and maintained with government grants and contracts—are used for commercial testing; their bookstores sell all kinds of books, not just those required for study and research; athletic booster clubs permit the use of physical fitness facilities in return for tax-deductible contributions; and alumni associations offer tours and travel discounts as well as novelties such as sweatshirts, mugs and bookends.

Nonprofit hospitals repair and rent medical equipment; operate helicopter and tax services, health clubs, diet clinics and weight-loss programs, day care centres for senior citizens, and bill collection agencies; offer interior decorating, catering, and paging and telephone answering services; sell hearing aids and medicine; and provide office cleaning and laundry services. A 1985 survey of 700 nonprofit hospitals by the accounting firm of Ernst & Whinney found that one in three nonprofit hospitals was involved in commercial activities and most others were considering them.

Trade associations have nonprofit status and an industry is developing to assist them to exploit their commercial potential. *Association Marketing*, a monthly tabloid which publishes "materials relating to the marketing of association services and products", contains a "Non-Dues Income Idea Center" in each issue. The January 1987 issue provides a table listing "more than sixty different categories of non-dues income, ranging from accounting services to travel services, and more than 300 ways that associations can make money". Most of the ideas listed involve competition with for-profit firms, e.g., offering accounting, financial, debt collection, and inventory control services; operating an advertising agency; publishing books; arranging car rentals, tours, and travel; selling group insurance and legal services; operating an employment agency; selling novelties; renting office space; and auto leasing.

The American Association of Retired Persons (AARP), a nonprofit group whose only requirement is that members must be at least 50 years of age, publishes a magazine, sells all types of insurance, provides financial services (e.g., money market and mutual funds), and operates a mail-order pharmacy. Veterinarians face competition from nonprofit animal welfare organizations. The list is almost endless. Indeed, even churches have entered the travel and tour business.

Given the widespread and growing involvement of nonprofits in commercial activities, it is not surprising that persistent and increasingly vocal complaints have come from for-profit firms, especially small businesses, charging the nonprofit sector with "unfair competition". Large industrial firms have generally been immune from nonprofit competition as the entry of nonprofits into commercial activity follows a predictable pattern of exploiting expertise developed in their "charitable" endeavors to expand into related commercial activities. For example, YMCAs have entered the market for physical fitness and colleges and universities often use the skills in their communications and education departments to produce audio-visual materials for sale or rental. In other cases, nonprofits attempt to employ excess capacity in commercial pursuits. When cost-containment efforts by the federal government and insurance companies in the early

1980s reduced the demand for the services of nonprofit hospitals, some private nonprofit hospitals utilized their idle capacity by entering numerous commercial markets related to the provision of health care such as operating laundries and producing frozen meals.

Thus, because of the nature of their commercial activities, nonprofits compete disproportionately with firms in the small business sector and the burden of unfair competition is not shared equally by all for-profits. Small for-profit firms are crowded out of the areas where nonprofits compete unfairly, existing firms are driven from the market or are discouraged from expanding, and the rate of formation of new firms is reduced.

The Response of the United States Courts

At root, unfair competition is a constitutional issue, for the United States Constitution guarantees all persons "equal protection of the laws" and, from a legal perspective, all business entities are "persons". Thus, the same rules and regulations should be applied to all organizations engaged in identical commercial activities. Although no case has yet reached the United States Supreme Court, for-profits have begun to challenge the charitable status of commercial nonprofit enterprises in state and municipal proceedings and the courts have begun to find that all activities of charities are not necessarily "charitable".

In Oregon, Pennsylvania, and Illinois, courts have withdrawn tax exemptions from YMCAs that have become essentially private health club businesses. Federal law requires an organization to have charitable activities as its "primary purpose" to be granted tax-exempt status, but the courts found that only about 10 per cent of the Ys' revenues supported charitable activities and much of the funding for even that small percentage probably came from United Way contributions and other donations, not from profits earned on health club facilities.

In *Intermountain Health Care* v. *Utah County* (1985), 709 P.2d 265, evidence showed that a nonprofit hospital chain, the largest non-utility employer in the state, had a profit margin of 10.9 per cent in 1985. Yet, "Intermountain was losing... only 3.3 per cent of revenues on patients who couldn't pay, while for-profit hospitals in the state were losing 4 per cent to 5 per cent". The Utah Supreme Court "found a nonprofit hospital system to be no different than profit-making systems and refused to give it state property tax exemption". In a similar case, three nonprofit hospitals in Pennsylvania lost their tax exemptions in 1988. Other cases are pending.

The Economic Consequences of Unfair Competition

Since the mid-1970s, the small business sector has been the primary source of new jobs in the United States economy as large firms have retrenched. Thus, unfair competition reduces job growth and employment opportunities in the for-profit, taxpaying sector. Although jobs are created in the nonprofit sector, a distortion occurs because nonprofits, like governmental enterprises, are inherently inefficient. Public firms and nonprofits are largely insulated from efficiency-enhancing competition because their operations are subsidized and the profit motive is attenuated, if it exists at all.

In effect, some of the jobs created in the nonprofit sector represent disguised unemployment. The small business sector is a particularly important avenue of employment for relatively unskilled workers—especially teenagers who are seeking the first jobs which provide the work experience that is indispensable to a successful working career. To the extent that entry-level jobs are threatened by unfair competition, many employment opportunities are lost. Thus, unfair competition places a disproportionately heavy burden on new entrants into the work force for whom these jobs often represent the only alternative to poverty. Among this group are racial minorities which, because of racism, inferior educational opportunities, and other factors, already have limited economic opportunities.

Unfair competition also adversely affects women, who have entered the labour force in unprecedented numbers over the past 30 years, because women are particularly active in the small business sector. Many, after gaining managerial expertise and experience in large corporations, become active in small family firms and in enterprises they start up themselves. About 28 per cent of all for-profits in the United States were owned by women in 1982, compared to only seven per cent in 1977. By 1984, women owned about one-third of United States firms, accounting for 3.4 million sole proprietorships that generated $56 billion in revenues.

Finally, when nonprofits displace for-profits, productivity problems are compounded. The weak incentives for efficiency in the nonprofit sector (due to their artificially lowered costs) relative to the private sector imply that productivity growth is likely to be slower. Because of the link between productivity increases and increases in real wages, the incomes of United States workers will grow less rapidly as nonprofits crowd for-profits from markets.

A Simple Solution to Unfair Competition

Unfair competition is not only inequitable in the sense that nonprofits and for-profits engaged in identical commercial activities operate in different tax, regulatory, and subsidy environments, but it also distorts markets and can be an inefficient way of dealing with the social problems which charities are established to address. Some nonprofit managers readily admit that the competition is unfair, but argue their special legislative privileges are justified because the profits earned are at least partly used to subsidize charitable activities, e.g., a YMCA may cater to affluent professionals but divert some of the profits to disadvantaged boys.

Since aiding these or other worthy individuals benefits the public, the use of general tax revenues for financing, rather than unfair competition, makes more economic sense for at least two reasons. First, the costs would be explicit and better known to both consumers and taxpayers. Unfair competition hides the true cost of social policy and, because unfair competition produces so many indirect and hidden costs, the costs may be much higher than direct income transfers or other more direct means of financing social policy. Second, if general revenues were used, a disproportionate share of the taxes for social services would not be paid, indirectly, by the owners, managers, and employees of private enterprises who compete with commercial nonprofits. Tax and regulatory policies that place for-profits at a commercial disadvantage are implicitly tax increases in that they reduce the income-earning opportunities of some individuals and transfer that income to the managers, trustees, employees, and clients of nonprofits. Private business owners should not disproportionately bear the burden of public goods i.e., a discriminatory tax.

It is important to emphasize that competition *per se* is not the problem: nonprofit organizations should be free to engage in any commercial activity since competition is beneficial. The critical issue is how to eliminate *unfair* competition without undermining the charitable and public service activities of nonprofits. There is a simple, straightforward solution: nonprofits that engage in commercial activity must do so through a for-profit subsidiary subject to the same laws and regulations that apply to the for-profits with which they compete. When for-profit firms offer essentially the same goods and services in the market and claim harm from unfair competition by nonprofits, the nonprofit activity should be deemed "commercial" in nature and operated through a for-profit subsidiary. This approach eliminates unfair competition, separates the charitable and public service components of nonprofits from their commercial operations, and explicitly recognizes that their charitable and commercial functions are fundamentally different.