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Explaining unrestricted giving by charitable foundations: A transaction cost approach☆

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ABSTRACT

This paper extends a transaction costs framework to the nonprofit sector where information asymmetries are typically acute. I explore the decision of charitable foundations to place material restrictions on grants to nonprofits. Foundations often place constraints on grant use to limit cross-subsidy of projects or ex-post opportunism by nonprofit managers. In contrast, nonprofits prefer fewer restrictions to smooth income across revenue streams or compensate for shifts in demand. The paper utilizes a pseudo panel of 6000 grant contracts to examine the relationship between the various costs of those restrictions and the observed characteristics of grant contracts. Empirical results confirm received theory that high contracting costs will reduce the probability of grant restrictions.

1. Introduction

In the U.S., nonprofits provide key services such as healthcare, education, the arts, and human services. Arrow (1963) noted that nonprofit organizations flourished in industries where the quality or quantity of output was particularly difficult to observe. In such industries, stakeholders face a hidden-action problem where profit-maximizing firms have an incentive to shirk on non-contractible elements of the production process. Hansmann (1980) later characterized the nonprofit organizational form as a mechanism for stakeholders to mitigate hidden-action or hidden-information problems, particularly when complete contracts are difficult to write. Presumably, the legal commitment by nonprofit managers to a non-distribution constraint softens the incentives toward opportunistic behavior.

Contract failure remains a central theoretical rationale for nonprofit formation (Glaeser & Shleifer, 2001). Yet, empirical evidence supporting the theory has been more difficult to obtain. This paper contributes to understanding the role of incomplete contracts in nonprofit formation by analyzing the particular issue of a charitable foundation's choice in offering restricted grants to nonprofit organizations. Institutional characteristics of the grant-making process allow us to observe some important components of incomplete contracts among nonprofits that are more difficult to observe elsewhere.

This paper presents a unique dataset of grant contracts between private foundations and recipient charities. To interpret variation in contract structure, a transaction cost economics (TCE) framework is applied to generate testable hypotheses about conditions where foundations will likely place restrictions on the use of grant funds. The paper extends empirical analysis of incomplete contracts to the nonprofit sector, which is largely unexplored. Consistent with TCE, empirical results indicate that foundations are more likely to place restrictions on grants as the costs of monitoring/enforcing grant restrictions decline or as the propensity for opportunistic behaviors rise. An empirical examination of contractibility within the nonprofit sector opens the door for an improved understanding of nonprofit formation, capitalization, and behavior.

2. Motivation

Reliance on grant restrictions by foundations has been a consistent debate within the nonprofit sector (Krehely & House, 2005). Throughout the 1990 s, the fraction of grant monies classified as unrestricted fell by more than 5 percentage points. By the year 2000, only 11.5% of total grant monies were classified as unrestricted. Unrestricted grants have rebounded in recent years, accounting for roughly 18% of foundation grant dollars in 2005. The underlying determinants of grant restrictions have a strong connection to the TCE literature, but this connection has not yet been explored.

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The paper treats grants as a production contract between charitable foundations and recipient nonprofit firms. As with for-profit firms, complex contracts among nonprofits are typically incomplete. The key insight of TCE is that economic transactions vary in their cost to design, negotiate and monitor. Consequently, governance mechanisms (contract design) will economize on those costs (Williamson, 2002).

2.1. Previous research

The development of the TCE framework is primarily attributed to Oliver Williamson (Williamson, 1975, 1985, 1979, 2002).[1] The analytic power from Williamson's work comes from his characterization of three key dimensions of transactions. He proposes that contracts matter when assets are specific to the production process. Relationship-specific investments are then subject to ex-post exploitation. The cost of mitigating this potential for exploitation depends on the uncertainty surrounding the contracting environment and the frequency of the transaction. Contracts will generally become more complete when the costs associated with creating those contracts are reduced. Indeed, three decades of research has demonstrated that nearly any contract can be explored along these dimensions (Williamson, 2002).

While there have been significant theoretical advances characterizing incomplete contracts, empirical evidence has lagged. Empirical progress has been hampered by difficulty in measuring the relevant concepts of observability, verifiability, and contract completeness. Even more difficult is the persistent problem of endogenous matching of agents to contracts. Ackerberg & Botticini (2002) document the consequences of ignoring heterogeneity among contract participants and offer some practical empirical solutions. Despite these challenges, there have been some recent advances.

Kaplan & Stromberg (2004) examine a set of 213 investment contracts by 14 venture capitalist (VC) firms. They find that VC firms typically construct agreements in order to minimize the costs of ex-post opportunism as well as the monitoring burden on the VC firm. The tradeoff between agency and monitoring costs appears to play a key role in VC contract design. In a similar work, Baker & Hubbard (2003) exploit an exogenous change in monitoring technology among trucking firms to examine innovation in contract provisions. They find that lower monitoring costs, through new technology, encouraged the integration of shipping firms into trucking.

Aggarwal (2007) takes up the more familiar issue of agricultural contracts. Using survey data, she examines groundwater contracts in rural India. Contracts among growers are typically incomplete due to a series of incentive and monitoring costs. Her empirical findings favor a transaction costs explanation of these contracts over traditional principle-agent models of risk sharing. A common theme among these papers is the use of production contract as the unit of observation. The governance form of the contract is regressed on specific characteristics of the contracting environment. This paper will follow that general approach while exploiting some unique institutional characteristics of the nonprofit sector to gain new insights.

The paper makes two distinct contributions. A general contribution is made to the TCE literature by offering new empirical evidence on incomplete contracts within the nonprofit sector. While there has been steady progress in understanding contracts among for-profit firms, I am aware of no other empirical study examining similar issues among nonprofits.[2] Second, nonprofit capital markets are under-studied in their own right. Foundations play a significant role in financing and monitoring the activities of nonprofits. A more complete understanding of the mechanism by which capital is allocated within the sector should lead to greater efficiency and effectiveness of those agencies which receive funding.

The paper is organized as follows. Section 3 motivates the paper by discussing the distinct institutional characteristics embedded within the grant-making process. Section 4 describes the sample data of charitable grants by foundations and its linkages to financial information provided by the recipient nonprofit organizations. In this section a set of proxies for both contractibility and the potential for ex-post opportunism by the nonprofit are introduced.

Section 5 develops an empirical model which relates those proxies to the probability of formal grant restrictions by foundation. The empirical findings demonstrate that foundations behave much like VC firms or agricultural contractors. Foundations appear more likely to impose grant restrictions when recipient nonprofits have a greater opportunity to pursue sub-goals or the costs associated with creating, monitoring, and enforcing those restrictions are low.

Section 6 addresses legitimate concerns regarding unobserved heterogeneity, particularly among foundations, which would encourage endogenous matching of grant contracts. The original cross-section is expanded to include two additional years of grant observations. Using repeated observations of foundations operating across years, this section attempts to control for unobserved heterogeneity among foundations. The final section explores the limitations and potential extensions of the work.

3. Institutional characteristics of the nonprofit sector

Grants made by charitable foundations to recipient nonprofits can be viewed similarly to production contracts made by for-profit firms. Donors make financial gifts to nonprofit organizations with the expectation that those gifts are an input into the charitable organization's production process. Yet, donors face a common agency problem where the preferences guiding the nonprofit will not perfectly match those of the donor.

3.1. The nonprofit organizational form

The nonprofit sector includes a vast array of organizations, ranging from hospitals to homeless shelters. Often the term nonprofit is equated with charity. However, the term charity more accurately describes a particular sub-set of nonprofits which receive preferential tax treatment under section 501(c)(3) of the U.S. tax code.[3] These privileges include the ability to offer tax deductions to donors as well as exemption from federal income tax. To receive tax-exempt status the organization must pursue a charitable objective, as defined by the IRS (Hopkins, 2003). This paper restricts its attention to tax-exempt charitable organizations.

The key economic distinction of the nonprofit organization, however, is its voluntary, public and permanent prohibition against private inurement.[4] While a manager has operational control of firm assets, ownership rights are attenuated because there can be no legal claimant to residual earnings. The consequences of this separation of ownership from control were formalized by Jensen and Meckling (1976). They demonstrate how the cost of slack to the manager will decline in line with their ownership rights. The application of

[1] Williamson's work drew from previous research including: the cost of obtaining information (Stigler, 1961), the coordination of investments (Alchian & Demsetz, 1972), and the measurement of output (Barzel, 1982). Jensen and Meckling (1976) also demonstrated how incentive alignment and the possibility of ex-post opportunism will increase contracting costs.

[2] Krashinsky (1986) offers a compact summary of the underlying theory of TCE as it bears on the nonprofit sector.

[3] Examples of nonprofits which are not charities would be political advocacy groups, mutual benefit organizations such as business trade groups, or fraternal societies.

[4] The private inurement doctrine prohibits 1) the transfer of income or assets away from the organization, and 2) the use of organizational income by a person closely associated with the organization for inappropriate purposes (Hopkins, 2003).