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Precautionary savings and the governance of nonprofit organizations

Raymond Fisman[a,*], R. Glenn Hubbard[b,1]

[a]Graduate School of Business, Uris 823, Columbia University, New York, NY 10027, United States
[b]Economics and Finance, Graduate School of Business, Uris 101, Columbia University, New York, NY 10027, United States

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Abstract

We present a model of nonprofit governance built on two assumptions: (1) organizations wish to hold precautionary savings in order to smooth expenditures; and (2) it is relatively easy for managers to divert these funds for personal use. Hence, donors face a trade off between expenditure smoothing and donation dissipation. We examine the model's predictions using panel data on U.S. nonprofits. We show that organizations in states with poor government oversight have managerial compensation that is more highly correlated with inflows of donations and allocate a smaller percentage of donations to the endowment for future expenditures relative to organizations in strong oversight states.
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The defining characteristic of nonprofit organizations is the nondistribution constraint (Hansmann, 1996). As a consequence, there are no shareholders that may absorb financial shocks to the organization. These fluctuations could be absorbed by employees through varying wages or employment, or recipients of the organization's services through changing program services. However, employees wish to smooth consumption, and the

* Corresponding author. Tel.: +1 212 854 9157; fax: +1 212 854 9895.
E-mail addresses: rf250@columbia.edu (R. Fisman), rgh1@columbia.edu (R. Glenn Hubbard).
[1] Tel.: +1 212 854 2888; fax: +1 212 932 0545.

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organization may wish to smooth program expenditures to maintain continuity of services. Holding precautionary savings is an alternative that is utilized by many nonprofits to guard against adverse revenue or expenditure shocks. Fisman and Hubbard (2003) presents results that are broadly consistent with the use of a fund balance as a precautionary savings device, but further note that the presence of a fund balance to smooth service expenditures may facilitate managerial 'stealing,' analogous to the free cash flow problem described by Jensen and Meckling (1976) in for profits. This possibility creates a dilemma for nonprofit donors-they may insist that funds be spent right away, thereby ensuring that their donations are put to good use at the expense of the production smoothing ability of the organization. Consistent with this idea, they find that the fraction of revenues derived from donations is lower in states with poor oversight of nonprofits.

In this paper, we build on this earlier work by presenting a model that crystallizes the intuition of this 'donor's dilemma,' and examining how this dilemma is affected by monitoring technologies. We use this model to generate additional predictions that relate to the sensitivity of diversion and precautionary savings to donation inflows. These predictions relate to changes over time within an organization, and hence generate more compelling empirical tests that further allow for the inclusion of organization fixed-effect to better control for unobserved (level) differences across firms. Specifically, our model predicts that there will be more diversion by managers if oversight is weaker, and hence donors will be less willing to have donations put into discretionary funds. We study these predictions using data from U.S. nonprofit organizations by taking advantage of cross-state differences in nonprofit oversight. We find that governance problems are greater in nonprofits in states with weaker oversight by the State Attorney General, as indicated by a higher sensitivity of executive compensation to the inflow of private donations in these states. We also find evidence that donors respond to these concerns by limiting the use of donations as precautionary savings, as indicated by a decreased sensitivity of fund balances to donation inflows in states with poor oversight. These findings are closely related to the pay sensitivity regressions that have become prevalent in the corporate finance literature (see, for example, Bertrand and Mullainathan, 2001), which shows that for profit managers are able to extract higher salaries from exogenous increases in cash flow. Our findings suggest a parallel set of governance issues affect the functioning of nonprofit organizations.

The rest of the paper is structured as follows: in Section 1, we provide a model that formalizes the key features of the donor's dilemma. The data we use are described in Section 2, and we report our results in Section 3. Section 4 concludes.

1. A simple model of nonprofit governance

To fix ideas, consider the problem faced by a not-for-profit entrepreneur who derives utility from providing a charitable good. The entrepreneur must raise donations to finance the provision of the good in two periods. The output of the good produced by the not-for-profit firm over the two periods is Q_1 in the first period and Q_2 in the second period; the cost of the good is unity. The entrepreneur receives donations D_1 from a "pioneer" donor in the first period. Because of the nondistribution constraint on the firm, those donations may be used to finance current production of the good (Q_1) or carried over as fund

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