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9-1-2010

The Power of Warm Glow

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Repository Citation

Usha Rodrigues, *The Power of Warm Glow* (2010),

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Response

The Power of Warm Glow

Usha Rodrigues

Professor Brian Galle’s *Keep Charity Charitable*¹ is a thoughtful contribution to the ongoing conversation about the proper tax treatment of charitable organizations. I largely agree with Galle’s arguments, but I would like to offer two criticisms of his positions: first, Galle overstates the problem posed by for-profit firms offering charitable services; and second, he understates the power of “warm glow” in the nonprofit organization.

Galle responds chiefly to a provocative 2007 essay by Anup Malani and Eric Posner, who suggested that for-profit firms that engage in charitable work should be taxed like their nonprofit charitable equivalents, Section 501(c)(3) organizations.² They argue that if a for-profit organization dedicates itself to charitable work, it should not pay federal taxes on its income, and any contributions made to the for-profit should be tax deductible to the donor.³

Alluring, isn’t it? All Malani and Posner are saying is: Give for-profits a chance.⁴ If for-profits do the same good work nonprofits do, they should be taxed equally.⁵ On the face of things, that seems only fair. As pie-in-the-sky thought experiments go, it’s a beauty.

Enter Professor Galle, who sets out to make mincemeat of the Malani–Posnerian pie. Galle argues that “society perceiv[ing] an organization as charitable is a critical element of the entity’s success.”⁶ This

1. 88 TEXAS L. REV. 1213 (2010).

2. Anup Malani & Eric A. Posner, *The Case for Non-profit Charities*, 93 VA. L. REV. 2017 (2007).

3. *Id.* at 2025–27.

4. *Id.* at 2065.

5. *Id.* at 2023.

6. Galle, *supra* note 1, at 1215.

observation is spot-on, although I will suggest a little later that Galle does not develop it quite as far as he can. Let me first, however, offer a few observations about Galle's other criticisms of the Malani–Posner proposal. Like almost everyone, Malani and Posner take Henry Hansmann's elegant contract-failure theory as a starting point for analyzing nonprofits.⁷ In his seminal work *The Role of Nonprofit Enterprise*, Hansmann argued that the nonprofit form's nondistribution constraint—its hallmark—arises because of the gap between the donor to a charity and the beneficiary of that charity.⁸ For example, say that you are trying to help recent earthquake victims, and you discover an organization named “Help to Haiti” that purports to be able to feed and house these individuals. Your problem as a donor is that you can't directly ask the Haitians you've tried to help though this organization if your money actually went to them or was instead siphoned off by the managers of Help to Haiti.⁹ But, as Hansmann's story goes, if that intermediary is bound by the nondistribution constraint, and thus has no owners because it is constitutively prohibited from taking profits, at least you have some comfort that your donation will really aid the needy Haitians you mean to assist.

Cold comfort, say Malani and Posner. They point out that a for-profit firm can achieve by contract the same assurance that is provided by the structural nondistribution constraint imposed on nonprofits by law.¹⁰ All the private firm need do, according to Malani and Posner, is to agree with donors not to distribute profits in excess of a specified amount and then hire a professional monitor to police the contractual arrangement.¹¹ Indeed, in the universe envisioned by Malani and Posner, use of for-profit charities will be *better* for donors because the profit motive will discipline for-profit firm managers to operate efficiently so that donations will be used in the most cost-effective and productive ways.¹² Galle answers, quite rightly, that credible monitoring is costly, and monitoring costs currently borne by the public at large would fall disproportionately on small charities.¹³

While Galle's responses to Malani and Posner are in general well reasoned, in two respects they seem to me to fall short. My first concern stems from Galle's discussion of “mixed firms,” that is, firms that engage in both charitable and noncharitable work.¹⁴ The principle espoused by Malani and Posner logically extends to these firms. Thus, for example, when

7. Malani & Posner, *supra* note 2, at 2035 & n.33.

8. Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 *YALE L.J.* 835, 838, 848 (1980).

9. Of course, consumer-protection laws, like false advertising, also now help protect against this type of fraud but were less developed when the nonprofit form arose.

10. Malani & Posner, *supra* note 2, at 2035.

11. *Id.* at 2035–36.

12. *Id.* at 2022.

13. Galle, *supra* note 1, at 1219.

14. *Id.*

Starbucks sells “Fair Trade Coffee” or Delta Airlines offers carbon credits for a ticket purchase, corporations should receive the same tax benefit as do nonprofit entities.¹⁵ Galle objects that sorting a firm’s noncharitable work from its for-profit work would be unduly burdensome in the “mixed-firm” world.¹⁶ I worry, however, that on this point Galle has overplayed his hand. The need for costly third-party monitoring, after all, seems far less important for firms such as Starbucks or Delta Airlines than for the archetypal case of a start-up for-profit charity. Starbucks and Delta enjoy valuable brands. As a result, the marginal return to them of skimping or cheating in their charitable enterprises would not be worth the loss of reputational capital they would suffer if they were exposed as exploiting farmers for a profit or knowingly lining their pockets instead of decreasing emissions. In contrast, start-up entities, with less of a name to lose, would be much more in need of the services of a costly professional outside monitor. This point may grow in significance given the recent surge in for-profit mixed-charitable activities.

My second concern focuses on Galle’s treatment of “warm glow,” a specific kind of utility that comes from giving. The threat of agency costs—that is, the threat that the firm’s managers are shirking, stealing, or otherwise not serving their principal’s interests—lurks in every organizational form, from general partnership to corporation to nonprofit. Malani and Posner argue that for-profits offer lowered agency costs because nonprofit managers may more aggressively rent seek or slack on the job.¹⁷ In contrast, if working at a nonprofit offered the possibility of a profit, and the attendant increase in wages a healthy profit promises, then more talented managers focused on delivering the best services would seek employment in the for-profit charitable-business sector.¹⁸

Galle is unconvinced. He says that many employees are motivated to work for charitable entities precisely because “peers will know that the employee is making a sacrifice.”¹⁹ And this drive to warm-glow compensation reduces costs unrelated to the charitable mission. Put another way, nonprofit managers are “true believers” who are less likely to rent seek or tolerate inflated administration costs because such behavior is incompatible with the “mission” they have chosen to make their own work.²⁰ Thus, warm glow functions as a strong form of norm, policing agency costs

15. Malani & Posner, *supra* note 2, at 2062–63.

16. See Galle, *supra* note 1, at 1220 (explaining how mixing charitable and noncharitable enterprises in the same firm would require the IRS to identify charitable functions with much more specificity than it does today).

17. See Malani & Posner, *supra* note 2, at 2055–56 (asserting that competition amongst nonprofits is at such an insufficient level that managers will act to improve the performance of the nonprofit only when it is threatened with insolvency).

18. *Id.* at 2056.

19. Galle, *supra* note 1, at 1223.

20. *Id.* at 1224.

not through custom but through constitution in a way that naturally suppresses behavior that is incompatible with the organization's purpose.²¹ By this logic, flying first-class on a humanitarian mission would be incoherent.²² Thus, locating the charitable enterprise within a for-profit organization—as Malani and Posner would have us do—irreparably cheapens it, “undermin[ing] the benefits of warm glow for everyone.”²³ Any gain in talent is more than offset by the heightened costs of monitoring and, even more, by the destruction of the warm glow.

Galle's assessment of warm glow's benefits is persuasive, but I would suggest that it is incomplete because it focuses only on employees. Just as employee's warm glow is dimmed by participating in a for-profit charity, so too is a *donor's* warm glow diminished.²⁴ Imagine that the individual who wants to help the Haitian homeless can choose between two organizations. One is a nonprofit. The other, a for-profit, contracts that it will pay 80 cents on the dollar to the Haitians and further contracts with PricewaterhouseCoopers to monitor its results. The understanding is that the entrepreneur will pocket 20% of all donations, minus administrative costs.

From the donor's perspective, one clear danger is that the for-profit would skimp on quality outputs to decrease administrative costs.²⁵ But there is an even deeper problem—the very knowledge of the profit making by the owners of the charity dims the donor's warm glow.²⁶ The difficulty is that the transaction is no longer about caring individuals coming together to help suffering Haitians. It is instead about forming an uneasy alliance between altruistic donors and entrepreneurs bent on making a buck. Knowledge of the economics of the transaction, the ultimate profit motive of the for-profit charity entrepreneur, the risk of contract failure, and the inability to measure desired outputs combine inexorably to produce the suspicion that the donor is really just a sucker.

In short, there is something very special about charitable warm glow. For example, a local nonprofit food cooperative is selling more than the free-range eggs or organic strawberries that Whole Foods and other for-profits market so effectively. The co-op offers community participation and an investment in local farms, a distinctive ethos that is incompatible with the

21. *Id.* at 1224–25.

22. Naturally the reader can think of charities rife with clear rent seeking—United Way springs to mind. But agency costs are present in firms of every organizational stripe, from partnership to for-profit corporation. The point is that agency costs are less prominent in nonprofits than one might expect because of warm-glow mechanism.

23. Galle, *supra* note 1, at 1224.

24. Indeed, Galle himself suggests this point by observing that individuals can derive warm glow from participating in charity, and that may be a significant motivation behind giving. But Galle's focus is on the incentives of a charity's *employees*, not its potential donors.

25. Galle, *supra* note 1, at 1228.

26. *Id.* at 1224–25.

profit motive and closely connected to the construction of an individual's social identity. I explore the special nature of the nonprofit more fully, and link it to the psychological concept of social identity, in a separate work—*Entity and Identity*—forthcoming in the *Emory Law Journal*.²⁷ This sense of social identity is separate and apart from the warm glow that giving to a charitable nonprofit creates. Yet by generating both of these important values, the nonprofit form imparts something that the for-profit form cannot. The implication of this idea may be surprising: Malani and Posner's suggestion of equal taxation of for-profit and nonprofit charitable activities may not disadvantage nonprofits much at all. Even in a tax-neutral world, at least some nonprofits would continue to flourish because they offer a special kind of warm glow that for-profits cannot provide, the warm glow of participating in a nonprofit organization.

Brian Galle's article makes an important contribution to the nonprofit debate by revealing subtle difficulties in the approach taken by Malani and Posner. I agree with Galle that the nonprofit charities cannot be reduced to their tax-exempt status. Still, his discussion of mixed-firm charitable activity seems overly alarmist, given the realities of mixed-firm charitable work. His view of warm glow focuses on employees at the cost of assessing the power of warm-glow effects on *all* participants of a nonprofit charity. These differences aside, I look forward to continuing—both with Galle and others—the larger conversation about the role of nonprofits in our society.

27. Usha Rodrigues, *Entity and Identity*, 59 EMORY L. J. (forthcoming 2010).