Overview of the Nonprofit Sector

America's nonprofit sector is large, complex, and diverse, including organizations very different from one another in purpose, size, and other characteristics. As Simon wrote in 1987, “The sprawling and unruly collection of animals that populate the nonprofit world—from churches to civil rights groups to garden clubs to the National Council on Philanthropy—makes this field hard to grasp and study all at once” (p. 69). And, as we will soon discover, the nonprofit sector is even more sprawling and unruly today than it was in 1987.

In this chapter, we will look at the nonprofit sector as a whole and establish basic concepts and definitions that will help bring some order to our understanding of its structure, boundaries, and characteristics. Let's start by taking a brief imaginary tour around one American city, starting from the author's office on the campus of The George Washington University, located near the center of Washington, D.C. As the nation's capital, Washington, D.C., is home to a significant number of nonprofits, but the variety of organizations that we will see on our tour is typical of what we might find in any American city. A walk through this one city helps give us a sense of the complexity to be found in today's nonprofit sector across the country.

Leaving the author's office at the University, we might walk past the George Washington University Hospital, then turn down the street and pass Western Presbyterian Church, just a few blocks from the edge of the campus. If it were morning, we likely would see men and women waiting to enter the basement of the church to visit Miriam's Kitchen, an organization that serves breakfast and provides other services to homeless people.

Another turn, and we would walk in front of the national headquarters of the American Red Cross and past the headquarters of the National Park Service. Proceeding farther into town, we would see the headquarters of the National Geographic Society and that of the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO). Eventually, we might walk past the Smithsonian Institution, located in several buildings along the National Mall, which extends from the Washington Monument to the Capitol building. If we continued our walk up Capitol Hill, we would pass the Library of Congress and the national headquarters of the Republican and Democratic parties. If the weather were warm, we might stop for some ice cream at Ben and Jerry's on Capitol Hill, before
turning back for the return walk to the campus. We could take a slight detour and come back
by way of 14th Street, which is home to several nightclubs. Among them we would see
HR-57, which offers live jazz performances. Arriving back at The George Washington
University, we might think about the various sights we have seen in our day and try to iden-
tify which are nonprofits and which are not. But that would not be as easy a task as it may
initially seem.

We have indeed encountered a number of nonprofits on our tour, but some seem more
nonprofit-like than others. When the word *nonprofit* is used, many people may think first
of an organization like Miriam’s Kitchen. While it is located in Western Presbyterian
Church, it is a separate organization from the church. It is small and supported almost
entirely by gifts. Its workforce is predominantly volunteers, and it provides its services to
people who pay nothing for them. Most people also would probably recognize the American
Red Cross as a nonprofit organization, which it is, although it is chartered by the U.S.
Congress and has a mandate from government to provide services to the U.S. military and
to the general population in times of disaster. Some might not think of Western Presbyterian
Church or other religious congregations as nonprofits in the same way as the Red Cross or
Miriam’s Kitchen, but religious congregations are indeed a part of the nonprofit sector. Some
may be surprised to learn that both the Republican Party and the Democratic Party, and
labor unions are also nonprofit organizations.

Some nonprofits don’t look or feel like nonprofits. HR-57 is a nonprofit music cultural
center in Washington, D.C., which takes its name from a resolution passed by the U.S. House
of Representatives in 1987, designating jazz as “a rare and valuable national American trea-
ure.” But it doesn’t seem that different from any other jazz club on 14th Street. On the other
hand, some organizations may seem like nonprofits, but the reality is more complex. For
example, The George Washington University Hospital, which we would have passed early
on in our walk, doesn’t seem any different from other hospitals that are nonprofit. But it is
in fact a for-profit hospital owned jointly by The George Washington University (a nonprofit)
and Universal Health Services (a for-profit hospital management corporation). Although it
is right down the street from Miriam’s Kitchen and provides services to some of Miriam’s
clients, as an organization it is really more like Microsoft than Miriam’s.

Several organizations display combinations of nonprofit missions and business opera-
tions. Our imaginary tour of Washington, D.C., touched two of these—the Smithsonian
Institution and National Geographic. The National Geographic Society is a nonprofit orga-
nization dedicated to geographic exploration and education. But National Geographic
Ventures is its wholly-owned-for-profit subsidiary that produces television programs, com-
puter software, and other products. The National Geographic Channel is a joint venture with
for-profit Fox Entertainment (http://channel.nationalgeographic.com/channel/intl, accessed
September 22, 2005). On cable TV, National Geographic competes with Discovery Com-
munications, operator of the Discovery Channel and a for-profit business corporation.
Although it looks and feels like any other ice cream shop, the Ben & Jerry’s on Capitol Hill
is indeed a business franchise owned by the Latin American Youth Center, a nonprofit orga-
nization based in Washington, D.C., that uses the shop as the foundation of a job-training
program as well as a source of additional revenue to support its mission programs.
The Smithsonian Institution is particularly complex, operating in part like a government agency, in part like a nonprofit organization, and in part like an entrepreneurial business. The Smithsonian receives a significant portion of its support from federal appropriations, but it was founded through a charitable bequest from John Smithson, after whom it was named, and it actively solicits philanthropic gifts for its museum exhibits, educational programs, research, and other nonprofit activities. A division called Smithsonian Business Ventures was created in 1999 and manages the business activities of the Smithsonian Institution, including theaters, museum restaurants, and museum stores. Such business ventures now provide $50 million to $60 million in unrestricted annual revenue to support the Smithsonian’s educational and research programs (Trescott, 2005, p. A01).

If the line between nonprofit organizations and for-profit businesses is sometimes difficult to distinguish, the line between the nonprofit sector and government itself is also increasingly blurry. Almost one third of the revenue of the nonprofit sector comes from government contracts and grants (Weitzman et al., 2002, p. xxxii), and some organizations exist primarily as government contractors implementing government-funded programs. But some government agencies also have begun to tap the private sector for support to supplement the funds they receive from tax revenues—including two we would have passed on our journey around Washington, D.C., the National Park Service and the Library of Congress. Both are agencies of the federal government that are increasing their efforts to raise private funds to supplement government appropriations.

Further confusing the landscape, there are for-profit companies that look, feel, and sometimes sound nonprofit-like in the way they describe their missions, programs, and goals. Some compete directly with nonprofits engaged in similar activities. Consider, for example, the following description of services offered by one organization:

We not only help our government and private-sector clients with their employment and training needs, we offer and deliver key services that address fundamental barriers to employment. These include: child care, transportation, counseling, and eligibility determination for federal programs that include Supplemental Security Income (SSI). (MAXIMUS Web site, www.maximus.com, accessed September 24, 2005)

That sounds like the description of a nonprofit organization’s programs, but it is indeed drawn from the Web site of MAXIMUS, a large for-profit corporation that manages government programs and employs 5,500 people in 280 different office locations.

Clearly the lines between the for-profit, nonprofit, and public sectors of our society are sometimes difficult to perceive without close examination. And the popular image of a nonprofit organization as a small band of volunteers intending to do good, working with minimal resources, serving people in need, and sharply distinct from business and government is far from the reality of many nonprofit organizations today. To understand how we came to where we are and make sense of the “sprawling and unruly collection of animals” that is today’s nonprofit sector, we will need some understanding of the
history that brought us to this point—and perhaps some road maps to lead us through the “zoo” (Simon, 1987).

AMERICA’S NONPROFIT SECTOR: A HISTORICAL OVERVIEW

The roots of America’s nonprofit sector lie in the ancient traditions of charity, philanthropy, and voluntarism. Steven Ott (2001, p. 90) identifies the Greco-Roman emphasis on community, citizenry, and social responsibility and the Judeo-Christian ethic of helping others as “two diverse ideological streams” that influenced these traditions in Western societies. But, indeed, virtually all cultures and religions include some emphasis on the importance of service to others, which includes giving or voluntary action.

The legal foundations of America’s nonprofit sector are drawn from English law, particularly the Statute of Charitable Uses and the Poor Law, both passed in 1601. These laws clarified the relationship between the British government and the Church of England, defined the legitimate activities to be supported by charity, and established a means to make the trustees of charitable institutions accountable (Hammack, 1998, p. 5). The philosophy reflected in these statutes influenced the development of U.S. law regarding nonprofits and is still reflected in American legal traditions.

Despite their ancient roots, it is in the United States that the traditions of charity, philanthropy, and voluntarism have reached their most elaborated expression. As early as 1835, the Frenchman Alexis de Tocqueville observed the unique propensity of Americans to form “voluntary associations” to address social and political objectives, which he reported in his famous book *Democracy in America*. Indeed, in a young nation born in revolution against the authority of the British government, voluntary organizations and institutions provided many of the services, from schools to volunteer fire departments. A certain mistrust of government has been a pervasive and continuing aspect of American culture and has provided philosophical support for private, voluntary initiatives throughout the nation’s history. As we saw in our tour of Washington, D.C., there appears to be some blurring of the nonprofit sector and government in today’s environment. But it is important to recognize that the blur was even greater in the earliest days of the nation, when government supported churches and churches sponsored many of the young institutions that served communities.

The beginnings of our modern nonprofit sector lie in the early years of the 20th century. Amidst the rise of great wealth resulting from the industrial revolution, charity and philanthropy became organized activities undertaken on a large scale. This was the time of great philanthropists such as John D. Rockefeller and Andrew Carnegie, who endowed universities, libraries, colleges, and other institutions across the nation. Carnegie’s essay, “The Gospel of Wealth,” published in 1900, remains a classic statement of the philosophy underpinning the American tradition of philanthropy. Carnegie expresses the responsibility of wealthy individuals to give back to the society that has enabled their accumulation of wealth, saying that “the man who dies rich dies disgraced.” Carnegie’s philosophy remains deeply a part of American culture, as evidenced by many contemporary entrepreneurs and investors, such as Bill Gates and Warren Buffet, who have created charitable foundations with similar expressions of obligation.
Carnegie also helped establish a distinction between the concepts of charity and philanthropy. Although the words are often used interchangeably and philanthropy is sometimes used as the broader, encompassing term, they describe two different types of giving. Charity is appropriately defined as giving intended to meet current individual human needs or to alleviate current human suffering—for example, to feed the homeless or aid the victims of a natural disaster. It is emotionally driven and often impulsive, as evidenced by the outpouring of gifts made through the mail, phone, and the Internet within days of the terrorist attacks of September 11, 2001, and Hurricanes Katrina and Rita in September 2005.

Philanthropy, on the other hand, is a more rational form of long-term investment in the infrastructure of society, seen, for example, in gifts made to construct new hospitals, endow universities, or create new charitable foundations intended to exist in perpetuity. If the goals of philanthropists were ultimately achieved, it is arguable that the need for charity would be eliminated, since there would exist institutions prepared to meet any human needs that might arise. However, in the imperfect world of the present, both types of giving are important and complementary in their impacts.

Some writers differentiate voluntarism (also called “volunteerism”) from charity and philanthropy, arguing that “charity and philanthropy may require little, if any, direct involvement with the beneficiaries [of the services provided],” whereas “volunteerism . . . is a very active process that requires active involvement with either the beneficiaries directly or an organization or group that serves a specific population” (Block, 2001, p. 101). Robert Payton (1988), on the other hand, makes philanthropy the umbrella term, defining it as “voluntary action for the public good,” including both the giving of time and the giving of money.

Despite its ancient roots and long history in the United States, the concept of a definable nonprofit sector, comparable with the for-profit and governmental sectors, is of relatively recent origin, dating to the work of the Commission on Private Philanthropy and Public Needs (the Filer Commission) in 1973 to 1975. The Commission’s report, titled “Giving in America,” was the first to characterize nonprofits as constituting a recognizable sector of society. The Filer Commission report came at a time when the nonprofit sector was expanding, reflecting in part changes in government policy. The 1960s and early 1970s were a period of increasing government spending on social programs, starting with the Great Society programs of President Lyndon Johnson. In many cases, government funds were channeled to nonprofit organizations, which provided the actual services. “Indeed,” Lester Salamon (2002) observes, “much of the modern nonprofit sector as we know it took shape during this period as a direct outcome of expanded government support” (p. 12). Beginning in the 1980s, under President Ronald Reagan, federal spending for social programs was sharply reduced, only to recover somewhat in the 1990s under President Bill Clinton. Since the 1980s, there has been a change not only in the level of government support but also in its form, with important implications for the management of nonprofit organizations. The shift has been away from direct grants to nonprofit organizations and toward providing aid to individuals in the form of voucher-type subsidies. This occurred, for example, in health care, where Medicare and Medicaid reshaped the industry. And, it occurred in higher education, where government funds going directly to colleges and universities diminished, while aid directed to individual students and their families increased. This created a new generation of student consumers and transformed higher-education institutions into competitive, marketing
organizations. This shift also was illustrated in the welfare reform legislation of 1996, which brought competition to many areas of human services. This empowerment of individuals as consumers through direct subsidies to them has forced nonprofits to compete for customer dollars not only with other nonprofits but also with for-profit companies that have entered fields previously the exclusive preserve of the nonprofit sector. For example, MAXIMUS is now among the nation’s largest managers of welfare-to-work programs.

These changes in government funding also account in part for the growing commercialization of the nonprofit sector itself, the increased need for professional nonprofit management, and the demands that nonprofits demonstrate greater accountability and results. Nonprofit organizations comprise a vital and growing sector of our economy and society, but questions about their effectiveness and accountability are topics of national discussion and debate. Some are even reassessing the meaning of concepts such as “community benefit” and “charitable purpose,” and the justification of tax exemption for at least some portions of the sector (see Salamon, 2002, pp. 28–29).

SEARCHING FOR A COMMON VOCABULARY

The nonprofit sector is so diverse and its structure is so complex that it is confusing to some people and there are various ways in which people understand it. Diverse understandings are reflected in the fact that there are multiple terms by which the sector is identified.

As Thomas Wolf (1999) points out, describing an elephant as a “non-horse” would seem to most people an unsatisfactory definition (p. 19). But the term nonprofit organization really refers to one thing nonprofit organizations do not do, rather than capturing much about what they are or the diverse programs and services they offer to society. One thing nonprofit organizations do not do is distribute profits to individual owners in the form of dividends or use those profits to enhance the wealth of owners through the increasing value of the enterprise.

It is important to dispel the common misunderstanding that nonprofits cannot earn profits. Defined as simply an excess of revenues over expenses, nonprofits can and do earn profits. But these profits must be retained within the organization and be used to further its programs rather than enrich individuals personally. This non-profit-distribution requirement, also called the nondistribution constraint, is one defining characteristic of nonprofit organizations. But it is clearly not the defining characteristic; indeed, by this narrow standard, the Department of Defense and the State of New York might also be called “nonprofits,” since they also have no stockholders or owners to whom any profit is distributed.

While the term nonprofit organization or just nonprofit is the most commonly used term in the United States, organizations that work internationally are generally known as nongovernmental organizations, although there is no identifiable nongovernmental sector with the same meaning as the term nonprofit sector in the United States. The term nongovernmental reflects in part the reality that many such organizations are performing government-like functions in the countries they serve and that most receive a substantial portion of their revenue from government sources. Many are like arms of government operating just outside the public sphere. Like nonprofit, the term nongovernmental
defines organizations by what they are not—they are not government agencies. But this term seems equally inadequate. It could apply as well to profit-making companies such as Intel and General Electric, which are also clearly nongovernmental in their ownership and legal control.

**ALTERNATIVES TO “NONPROFIT”**

While *nonprofit* is the term most commonly used to describe the sector, there is no shortage of proposed alternatives. Each alternative has its own virtues and shortcomings as well. The term *independent sector* has some prominence since it is also the name of the principal organization representing the interests of nonprofits in Washington, D.C.—Independent Sector (www.independentsector.org). But it raises the question of “independent from what?” Nonprofits are financially dependent on resources derived from both government and private donors and are subject to an increasing array of state and federal law, so independence would not seem to capture their essence.

Some prefer the term *third sector*, placing nonprofits in the universe alongside the commercial economy and government. The term is accurate in terms of size—both the business sector and government employ more people, generate larger revenues, and account for a larger share of economic output. But it also seems to imply a rank order of importance, which would not agree with the values of many people, who may consider religion, education, the arts, medical research, and other purposes served by the nonprofit sector to be among the most important of human endeavors. Furthermore, some scholars suggest that American society encompasses not three but four sectors: business, government, the nonprofit sector, and families and communities. In this broader array, it becomes more difficult to rank the sectors, except by size, in which case families and communities would come first and the nonprofit sector would be fourth rather than third.

The term *charitable sector* is sometimes used, but it is contrary to the reality that charitable gifts, while important, are not the largest source of nonprofit revenues. Nor is the term synonymous with *nonprofit sector*, since there are organizations that qualify as nonprofit under the U.S. tax code but that neither seek nor receive any form of charitable support. This is true, for example, of membership organizations that are funded entirely through dues and those nonprofits whose revenues may consist entirely of grants and contracts received from government. Nor does the term seem appropriate to encompass major institutions, such as Harvard University, that are nonprofit but hardly consistent with most people’s understanding of a charity.

Some use the term *voluntary sector*. Voluntarism is one of the foundations of the sector, and many organizations do indeed rely on volunteers, both as members of their governing boards and for at least part of their workforce. But the term does not reflect the reality that in many nonprofits, paid staff members far outnumber volunteers. It also may perpetuate an inaccurate image of nonprofits as universally small and amateurish in their operations, when, indeed, many nonprofits are substantial enterprises and professional management of nonprofits has been a growing trend.
The phrase *tax-exempt sector*, commonly used by accountants, attorneys, and other tax specialists, is similar to *nonprofit*. It identifies organizations entirely in terms of their status under U.S. tax law. Nonprofits are exempt from paying federal income tax and generally from state and local income taxes as well. But, again, *tax-exempt* speaks to the legal status of such organizations and says nothing about what they actually do. As we will discuss shortly, the sector encompasses a variety of organizations with few apparent similarities aside from their tax-exempt status.

Another term that has been proposed is *civil society sector* (Salamon, 1999, p. 9). There are many different definitions of *civil society*, and while “the nonprofit sector provides the organizational infrastructure of civil society,” the concept itself is more abstract, including “the sum of institutions, organizations, and individuals located between the family, the state, and the market, in which people associate voluntarily to advance common interests” (Anheier, 2005, p. 9). And as Salamon (1999) acknowledges, the term *civil society sector* is like *voluntary sector* in that it “emphasizes the citizen base” of these organizations, while most are not membership associations and many engage large paid staffs (p. 9).

In recent decades, nonprofits have come to be increasingly managed like businesses, and as we will discuss later, some undertake entrepreneurial ventures either directly, through for-profit subsidiaries, or with for-profit partners. Some have adopted the term *social enterprise* to characterize nonprofits that have a social objective but blend traditional nonprofit methods and commercial principles in their generation of revenue (Dees et al., 2001, p. 9). Although the term *social enterprise* is generally associated with those who especially advocate organizations’ operating like a business and undertaking efforts to increase revenues from commercial activities, it could be argued that the term captures the positive essence of *all* private organizations having a social purpose, perhaps better than *nonprofit*. Like companies, nonprofits bring together people, resources, and purposeful effort in pursuit of a mission, and they increasingly operate with plans, goals, and established criteria of success—they are indeed enterprises, but their missions relate to social purposes rather than to the enrichment of private individuals. Were *social enterprise* to become a general designation for all such organizations, the sector that contains them perhaps then would be called the *social sector* to differentiate it from business and government. Or, as Jon Van Til (2000) suggests, perhaps something like the French term *économie sociale*, or *social economy*, would be appropriate (p. 12). Indeed, *social sector* has become popular among some business authors in referring to the nonprofit sector (Collins, 2005). However, this broader meaning of the term has not yet gained universal acceptance, and we generally will use the more common designations of *nonprofit organization* and *nonprofit sector* in the remainder of this book.

**SIZE OF THE U.S. NONPROFIT SECTOR**

It is difficult to say precisely how many nonprofit organizations exist in the United States. One important type, religious organizations, are not required to register with the Internal Revenue Service (IRS), making it difficult to count their number. Until 2008, organizations with annual revenues less than $25,000 also were not required to register with the IRS and
thus were almost impossible to catalog or count. Indeed, many of the latter are not incorporated, and some are little more than informal groups of people who have come together to address some common interest or need.  

In the mid-1990s, the nonprofit scholar Lester Salamon (1999) estimated that there were 1,600,000 nonprofit organizations in the United States, including 400,000 that were “member-serving” and 1,200,000 that were “public-serving” (p. 22), terms that we will explain further below. In 1998, it was estimated that nonprofits employed almost 11 million paid staff members, constituting more than 7% of the U.S. workforce. Taken together as an “industry,” nonprofits employed three times as many people as agriculture, twice the number in wholesale trade, and nearly 50% more than are engaged in construction and finance, insurance, and real estate (Salamon, 2002, p. 7).

The number of nonprofits in the United States increased dramatically throughout the 1990s and into the 2000s. The total number of organizations grew by 62.4% between 1987 and 1997 (Weitzman et al., 2002, p. 12) and by 5.6% in 2003 alone (Gose, 2005). The years between 1999 and 2003 saw the creation of 35,000 new religious organizations, 30,000 new educational organizations, 28,000 human services groups, and 5,000 new organizations concerned with the welfare of animals (Gose, 2005). Thus, while the number of organizations cannot be precisely measured, it is clear that America’s nonprofit sector is large and growing, becoming an ever more important component of the U.S. economy and an increasing area of career opportunity.

The growth of the nonprofit sector is attributable to a variety of forces, including the trend that began in the 1980s toward the devolution of federal programs to state and local governments and outsourcing of the provision of many services to nonprofits by governments at all levels. Also contributing to the growth of nonprofits was the booming economy of the 1990s, which gave rise to an 81% increase in the number of foundations created by wealthy individuals and a doubling of foundation assets, making more money available to fund nonprofit programs (Gose, 2005). And, some argue, the growth of nonprofits has been fueled by a reawakening of the spirit of public service among the current generation of Americans. The requirement of community service for graduation from high school has exposed a generation of young people to the idea of volunteering. Events such as September 11, 2001, the 2004 tsunami in South Asia, and Hurricane Katrina in 2005 have called the nation’s attention to human needs and the role of nonprofit organizations in helping alleviate human suffering.

In his influential, although controversial, 1995 article, “Bowling Alone: America’s Declining Social Capital,” Robert Putnam discussed a decline in civic engagement among Americans, using the metaphor of his title to suggest that Americans were becoming more isolated and more involved in individual pursuits than in collective interests and activities. But a decade later, Putnam and his colleague Thomas Sander reported that young Americans who witnessed the events of September 11, 2001, in their adolescent years appeared more involved in public affairs and community life than their older siblings. As Sander and Putnam (2005) note, “We’ll have to wait some years to see if this budding civic engagement blossoms, but it could prove to be the largest civic shift in the past half-century” (p. A23).
DIFFERENTIATING THE NONPROFIT SECTOR

As we saw from our imaginary walking tour of Washington, D.C., nonprofits are a widely diverse group of organizations and institutions. Fortunately, there are ways of bringing order out of the apparent chaos by placing nonprofits into categories. Let’s review some of them and see if we can gain a clearer picture of this complex arena.

IRS Classifications

Perhaps the most practical way to divide the nonprofit sector is by the categories (or “classifications”) applied by the IRS in recognizing tax exemption. Nonprofits qualify for tax exemption under various sections of the Internal Revenue Code (IRC), depending on the nature of their principal activities. For example, political parties are qualified under Section 527 of the code and farmer's cooperatives under Section 521. But most tax-exempt nonprofits are qualified for tax exemption under one section of the IRC—Section 501 (c). Under Section 501 (c), there are a number of subsections into which a nonprofit may fit, again, based on the nature of its principal activities. About 70% of all nonprofits, including those emphasized in this book, fall under just two subsections of the code: Section 501 (c) (3) and Section 501 (c) (4) (Weitzman et al., 2002). Organizations that qualify under Section 501 (c) (3) are generally called “charitable nonprofits.” And organizations that qualify for tax exemption under Section 501 (c) (4) are called “social welfare organizations.” There are important differences.

Charitable Nonprofits

It is important at this point to distinguish two concepts: the tax exemption of organizations themselves and the tax deductibility of gifts made to them. All organizations qualified under Section 501 (c) of the IRS code are tax-exempt; that is, they are not required to pay federal taxes on their income. (Organizations exempt from federal income tax are usually also granted exemption from state and local income taxes.) However, only those classified under Section 501 (c) (3)—the charitable nonprofits—are both tax-exempt themselves and also eligible to receive gifts that are tax deductible for the donors. So, for example, the Republican and Democratic parties are tax-exempt organizations—they do not pay federal taxes on their own income. But they do not qualify under Section 501 (c) (3). They are not charitable organizations. If a donor makes a contribution to the Democratic or Republican party, he or she cannot deduct that gift from his or her individual income when calculating his or her own income tax due. But, if that individual makes a gift to a charitable, 501 (c) (3) organization, such as a church, college, or hospital, the gift is tax deductible, within certain limits.

The tax deductibility of gifts made to charitable nonprofits obviously provides a significant advantage to them in their fundraising efforts. Consider an individual donor who is in a 25% federal tax bracket and who makes a deductible gift of $100 to a charitable nonprofit organization. He or she can deduct that $100 from his or her income before calculating the income tax due. The donor’s taxable income is reduced by $100, so the donor’s tax bill is reduced by 25% of that amount, or $25. This is considered a tax saving, since, but for the gift, the donor would have paid that amount in additional federal income tax. The
out-of-pocket cost of the $100 gift is thus reduced, from $100 to $75 ($100 minus the $25 tax saving). Some view the saving as a form of tax subsidy, or tax expenditure, in the form of foregone federal revenue.

The tax deduction for gifts to charitable organizations is intended to encourage charitable giving and sustain the services provided by charitable organizations. Society has determined that the purposes they serve are to the public benefit and that if the nonprofits did not exist, those services might need to be provided by government. Being eligible to receive deductible gifts makes it easier for charitable nonprofits to raise funds, since the donors are, at least theoretically, able to give more because of the tax saving realized from the deduction.

To be recognized as tax-exempt under Section 501 (c) (3), an organization must demonstrate three things; in other words, it must meet three tests. First, it must be organized and operated for one or more of eight purposes: charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competitions, and prevention of cruelty to children and animals. (Curiously, the IRC does not specifically mention health care, although, as we will soon discuss, that is one of the largest components of the nonprofit sector.) The term charitable may seem somewhat imprecise, but IRS defines it to include certain specific activities:

- relief of the poor, the distressed, or the underprivileged; advancement of religion;
- advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening the burdens of government; lessening of neighborhood tensions; elimination of prejudice and discrimination; defense of human and civil rights secured by law; and combating community deterioration and juvenile delinquency. (www.irs.gov/charities/charitable/article/0,,id=96099,00.html, accessed August 3, 2006)

In addition to demonstrating that its primary purposes include one or more of those discussed above, a 501 (c) (3) nonprofit must meet two additional requirements. It must meet the nondistribution test, ensuring that its assets are not being used to benefit individual owners and that its managers are not being personally enriched through excessive compensation. And it must limit its political activities. A nonprofit qualified under Section 501 (c) (3) cannot support candidates for public office, and it must limit its expenditures on lobbying—that is, efforts to influence legislation.

Social Welfare Organizations

Social welfare organizations are tax-exempt because they work, in the IRS’s words, “to further the common good and general welfare of the people of a community (such as bringing about civic betterment and social improvements.)” But how is this different from the work of charitable nonprofits? One big difference between 501 (c) (3) and 501 (c) (4) organizations is that the latter do not face the same limitations on political activity that are imposed on the former. They can spend money on lobbying without limitation (www.irs.gov/charities/nonprofits/article/0,,id=96178,00.html, accessed August 3, 2006).

Because of that difference, 501 (c) (4) organizations are tax-exempt, but gifts made to them are not tax deductible. They often raise funds by encouraging individuals to become members or to make gifts, but the individuals do not earn a tax deduction for those payments.
Because of the different advantages enjoyed and disadvantages experienced by 501 (c) (3) and 501 (c) (4) organizations, in terms of the tax treatment of gifts and the limitations on lobbying, some organizations have two arms—actually two separately incorporated but related organizations. One is qualified under Section 501 (c) (3) and is thus eligible to receive tax-deductible gifts. It pursues education, research, and other activities consistent with that classification. The other organization is qualified under Section 501 (c) (4) and is free to engage in lobbying without restriction. It cannot receive deductible gifts, but it can raise funds through member dues and other types of revenue. Box 1.1 provides an example in the form of mission statements for the Sierra Club, a nationally known environmental organization, and the related Sierra Club Foundation. The Sierra Club itself is a 501 (c) (4) social welfare organization that works to preserve the environment, including lobbying for environmental-protection legislation. The Sierra Club Foundation is a 501 (c) (3) organization that supports certain activities of the Sierra Club. As its description carefully explains, the Foundation limits its support to those activities that are consistent with the “charitable, scientific, literary, and educational purposes” allowed for 501 (c) (3) organizations. Note the subtle differences in the mission statements of the two organizations. The Sierra Club’s mission includes “enlisting” humanity, which suggests the possibility of building political coalitions and encouraging individuals to political action, while the Foundation “empowers” the citizenry, something that might be accomplished merely by providing them with information—that is, through education—without any call to political action. These may seem like subtle differences, but facing the possibility of audit by the IRS and wishing to protect the tax status of both entities, most organizations are precise in monitoring their activities for consistency with tax law. Chapter 14 discusses lobbying in more detail, including relevant legal issues.

National Taxonomy of Exempt Entities

The IRS classifications of nonprofit organizations are obviously of practical importance because of the benefits and restrictions they convey. But they are also broad and lump together many organizations that in fact have significant distinctions among them. A more elaborated set of classifications is the National Taxonomy of Exempt Entities (NTEE). Maintained by the National Center for Charitable Statistics (NCCS), a program of the Center on Nonprofits and Philanthropy at the Urban Institute, the NTEE divides the universe of nonprofit organizations into 26 major groups under 10 broad categories. These categories are based on organizations’ purposes, activities, and programs and are similar to the industry classification codes used to group for-profit companies.

Box 1.2 lists the 10 broad categories in the NTEE. The complete taxonomy, which runs to two pages, along with explanations of the categories, is available on the Web site of NCCS (http://nccsdataweb.urban.org/FAQ/index.php?category=73).

Salamon’s Anatomy

Both the IRS classifications and the NTEE group organizations according to the principal activities in which they are engaged. Some have sought ways of categorizing nonprofits along other lines. Various scholars have attempted to develop maps to bring greater clarity to our understanding of the structure of the nonprofit sector (Gamwell, 1984; Smith, 1991;
BOX 1.1  Comparison of Charitable and Social Welfare Organizations

Mission of the Sierra Club, a 501 (c) (4) Organization
To explore, enjoy, and protect the wild places of the earth; to practice and promote the responsible use of the earth’s ecosystems and resources; to educate and enlist humanity to protect and restore the quality of the natural and human environment; and to use all lawful means to carry out those objectives.


Mission of The Sierra Club Foundation, a 501 (c) (3) Organization
The mission of The Sierra Club Foundation is to advance the preservation and protection of the natural environment by empowering the citizenry, especially democratically based grassroots organizations, with charitable resources to further the cause of environmental protection. The Sierra Club is the vehicle through which The Sierra Club Foundation generally fulfills its charitable mission.

Description of The Sierra Club Foundation
Working as a funding resource for the environmental community, The Foundation offers its services in receiving, administering, and disbursing funds for tax-exempt charitable, scientific, literary, and educational purposes both to the Sierra Club and to other environmental organizations and projects. Subject to federal tax codes that clearly define the activities with which we can assist, The Foundation is precluded from supporting electoral activities and can expend only a small part of its resources on influencing legislation. While The Foundation is autonomous and is governed by its own Board of Trustees, it works closely with the Sierra Club in pursuing its program and goals.


BOX 1.2  National Taxonomy of Exempt Entities (NTEE) Major Groups

<table>
<thead>
<tr>
<th>Arts, Culture, and Humanities</th>
<th>International, Foreign Affairs</th>
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<tr>
<td>Education</td>
<td>Public/Societal Benefit</td>
</tr>
<tr>
<td>Environment and Animals</td>
<td>Religion Related</td>
</tr>
<tr>
<td>Health</td>
<td>Mutual/Membership Benefit</td>
</tr>
<tr>
<td>Human Services</td>
<td>Unknown/Unclassified</td>
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</table>

Sumariwalla, 1983; Van Til, 1988, 2000). Among them is Lester Salamon’s *America’s Nonprofit Sector* (1999), which divides the universe of U.S. nonprofits into two broad categories, *member serving* and *public serving*, and then defines various subcategories on each side of that divide (p. 22).

As the term implies, member-serving organizations exist primarily to secure benefits for the people who belong to them or who support them through dues, membership fees, or other contributions. They include, for example, social and fraternal organizations, business and professional associations, and labor unions. In general, their sources of support and the beneficiaries of their programs are one and the same, although society may benefit indirectly—for example, through the improvement of skills among members of a profession that serves the public’s needs. These organizations are tax-exempt but not eligible to receive tax-deductible gifts. They are not charitable organizations. Salamon’s (1999) definition of public-serving organizations includes churches, the charitable and social welfare organizations we have discussed, as well as foundations and other “funding intermediaries.”

Salamon’s *Anatomy* (Salamon, 1999) provides another and a useful way to think about the nonprofit sector, classifying nonprofit organizations not by the nature of their activities, like IRS or the NTEE, but rather by who receives the principal benefit of those activities. But while it adds clarity in certain respects, it also raises questions. For example, Salamon puts churches in the public-serving category. They surely are tax-exempt and eligible to receive tax-deductible contributions—they are 501 (c) (3) organizations, but it seems possible that their activities might more directly serve their own members rather than the general public. He classifies political parties as member-serving organizations. It is true that they are not 501 (c) (3) organizations under the tax code. But it isn’t clear exactly what benefits their members derive from their affiliation (Anheier, 2005, p. 64). Despite its weaknesses, Salamon’s *Anatomy* (Salamon, 1999) has contributed to the vocabulary of the nonprofit field, and it is not unusual for some to refer to organizations as “member serving” or “public serving.”

The Independent Sector

Figure 1.1 provides a way to visualize the nonprofit sector and brings together the various types of organizations that have been mentioned so far. It is based on a diagram illustrating how the organization Independent Sector defines its membership. As mentioned previously, Independent Sector is the principal organization that represents the interests of nonprofits in Washington, D.C. Its membership generally coincides with Salamon’s (1999) public-serving organizations.

Figure 1.1 first divides society into the three sectors: government, nonprofits, and for-profit business. The nonprofit sector then is divided into four categories: (1) religious congregations, which are automatically tax-exempt under Section 501 (c) (3) and are not required to register with the IRS (Box A); (2) organizations that do register with the IRS under Section 501 (c) (Box B); (3) organizations that register with the IRS under sections of the tax code *other than* Section 501 (c)—for example, political parties that register under Section 527 (Box C); and (4) small, often informal organizations with minimal revenues (Box D).

Take a look at Box B, the 501 (c)s. They are further broken down into three categories: (1) the 501 (c) (3) charitable nonprofits (Box E), (2) the 501 (c) (4) social welfare organizations (Box F), and (3) other tax-exempt organizations that qualify under Section 501 (c) (Box G).
The latter includes, for example, some business associations that are under Section 501 (c) (6). Indeed, most of Salamon’s (1999) member-serving organizations would be within Box G. You will notice that the 501 (c) (3) organizations are further divided into two
categories—public charities (Box H) and private foundations (Box I). Let’s put that point aside for the moment and come back to it shortly.

MAJOR SUBSECTORS

The independent sector as a concept (and Independent Sector as an organization) encompasses Boxes A, F, H, and I in Figure 1.1. It is dominated by five subsectors—health services, education and research, social and legal services, religious organizations, and organizations in the fields of art and culture—that account for 92% of nonprofit revenues, 96% of paid staff working in the nonprofit sector, and 98% of all salaries and wages paid to nonprofit employees (Weitzman et al., 2002, pp. 46–47). The subsectors differ significantly in their sources of revenue, the degree of commercialization they reflect, and the extent to which their management has been professionalized—that is, the extent to which they are run by paid staff rather than volunteers.

Health Services

The health services subsector is the largest component of the overall nonprofit sector if measured by total revenue, the number of employees, and its share of total wages and salaries. It includes hospitals, home health agencies, outpatient clinics, hospice programs, nursing homes, health maintenance organizations, dialysis centers, community health centers, residential treatment programs for emotionally disturbed youth, and a variety of specialized institutions. The health services subsector is unique in that a small portion of its revenue comes from contributions (just 4% in 1997) and a large portion (42%) comes in the form of government payments. The latter reflects the impact of Medicare and Medicaid programs, which reimburse for services provided to individuals whom they have insured. Another 47% of health services revenue comes from private payments, including those made by private insurance companies and patients themselves, and 7% comes from other sources (Weitzman et al., 2002, p. xxxiv).

As its revenue pattern suggests, health services is the most commercialized of the nonprofit subsectors; that is, its organizations are businesslike in deriving most of their revenue from fees charged for services provided. Health services was one of the first subsectors to become professionalized in its management—that is, to develop large paid staffs rather than depend on volunteers. It is also a field in which nonprofits compete with for-profit firms to a significant extent. In some industries—for example, nursing homes—for-profits have captured the major portion of the market. Health services also has seen the conversion of some nonprofits into for-profit entities, including insurance plans, hospitals, and nursing homes.

Education and Research

Education and research is perhaps the subsector best known to students. It includes colleges and universities, preschool, elementary and secondary schools, correspondence schools, libraries, and various free-standing research institutions (or “think tanks”), such as the
Brookings Institution. It will not surprise students to learn that educational institutions receive a significant portion of their revenues from fees for service, including tuition, which accounted for 56% of this subsector’s income in 1997. Government payments provided another 19%; private contributions made up 13%; and 11% comes from other sources, including investment returns on endowment funds (Weitzman et al., 2002, p. xxxv). Higher education is a field in which professional management has increased in recent decades. While the senior executives of colleges and universities are still predominantly drawn from the academic ranks, on most campuses there has been a proliferation of midlevel management in areas such as fundraising, student services, and financial administration. Middle management has grown as colleges and universities have faced increased competitive pressures, greater governmental regulation, and the need to expand revenues through intensified fundraising programs.

While for-profit education firms—for example, the University of Phoenix—have grown in recent decades, most schools, colleges, and universities remain either nonprofit or government controlled.

Social and Legal Services

The social and legal services subsector, encompassing individual and family services, free legal aid, day care, residential care, job training, youth programs, and other such services, includes many of the organizations that many people would think about first when the term nonprofit is used. They are often small and community based. Social and legal services grew at a faster rate than any of the other charitable subsectors from the 1970s to the 1990s, reflecting in part the trends we mentioned before—the outsourcing of government programs to the nonprofit sector and government’s departure from some areas of activity altogether. Although many people might consider organizations in these fields as among the most “charitable,” indeed they are among the most reliant on government funds. Government payments constituted 52% of their revenue in 1997, with private contributions accounting for 20%, private payments making up 19%, and 9% coming from other sources (Weitzman et al., 2002, p. xxxvi). This dependence on government funds makes the social and legal services subsector the most vulnerable when public policy shifts and government social spending declines. For this reason, among others, many of the efforts to diversify revenues by developing alternative sources, including business enterprises, have been in this subsector, and also much of the discussion regarding the need for improved management and accountability in the nonprofit sector as a whole. In recent decades, professional nonprofit management has grown more rapidly in this subsector than in any other, increasing its share of total nonprofit employment from 13% in 1977 to 17.5% in 1998 (Weitzman et al., 2002, p. xxxv).

Religion

As we have noted before, religion is a unique component of the nonprofit sector. It is protected by the U.S. Constitution and the guarantee of religious freedom it provides. The principle of separation of church and state prevents government funds from going directly to
religious congregations or to organizations that would use them for religious activities. However, congregations are to be distinguished from faith-based organizations that provide social services, which can receive government funds to support their secular programs. Federal legislation passed in 1996, 1998, and 2000 included charitable choice provisions to allow faith-based organizations to receive grants under federally funded programs, and proposals to further increase the ability of faith-based nonprofits to obtain such funding generated controversy during the first term of President George W. Bush.

This book does not specifically discuss the management of religious congregations—that is, churches, synagogues, and mosques. Religious organizations are the least professionalized of the subsectors. Although there has been some growth in the number of church managers, the management of most congregations is still done by the clergy and volunteers. In 1998, religious organizations accounted for just 11.6% of paid employment in the charitable nonprofit sector (Weitzman et al., 2002, p. xxxvi). As a subsector, religion is also unique in that most of its revenue, 95% in 1997, comes from private gifts (Weitzman et al., 2002, p. xxxvi). Indeed, it is the largest single recipient of gifts, accounting for 35.5% of all giving in the United States in 2004 (Center on Philanthropy at Indiana University, 2005, p. 20).

**Arts and Culture**

The arts and culture subsector includes museums, orchestras, botanical gardens, zoos, performing arts groups, art galleries, nonprofit radio and television stations, literary societies, and other such organizations. Although it is the smallest, its revenue growth during the 1990s was the highest of the charitable subsectors (10.4% from 1992 to 1997). Arts and culture organizations receive substantial support through philanthropy, which accounts for 44% of their revenues. Private payments, including ticket sales and admission charges, provide another 28%, 10% comes from government, and about 19% comes from other sources (Weitzman et al., 2002, p. xxxvii).

The subsectors of health services, education and research, social and legal services, religion, and arts and culture account for the largest portion of the charitable nonprofit sector and are likely to be the most familiar to most individuals. They include many of the largest organizations and institutions, and many have a noticeable physical presence—for example, a campus, a hospital, a church, or a performing arts center. But there is another type of nonprofit organization that, while perhaps less visible, plays an important role in the nonprofit sector—what Salamon (1999) calls the “funding intermediaries,” including foundations and federated funders.

**Funding Intermediaries**

Funding intermediaries are organizations that exist for the sole purpose of directing money to other nonprofits (Salamon, 1999). They generally do not themselves operate programs that provide services directly to individuals. Rather, their role is, in a sense, to be like the bankers of the nonprofit sector, channeling private giving to other, service-providing nonprofits.
Federated Funders

Federated funders include organizations such as the United Way and the American Heart Association. They raise money from the public and then redistribute it to other organizations that serve their local communities, pursue the fight against certain diseases, or undertake other activities consistent with the purposes and priorities of the funder.

Foundations

Foundations are funding intermediaries, too. They are 501 (c) (3) organizations that, like the federated funders, generally do not operate their own programs but rather make gifts or grants to other nonprofits that do. Foundations are created by individuals, companies, and other donors, who give money to the foundation, generally earning a tax deduction. The way in which foundations then manage and disburse that money varies, but many retain the original gifts, invest them, and use only the income earned on those investments to make grants to operating nonprofits.

Public Charities and Private Foundations

At this point, it is necessary to complicate things still further by introducing two new terms. As we saw in Figure 1.1, there are two different types of nonprofit organizations that are exempt under Section 501 (c) (3)—public charities [Box H] and private foundations [Box I]. There are technical definitions of these terms established in tax law, but it is sufficient to understand that public charities, as the term suggests, are organizations that receive support from the public, meaning that they have a relatively large number of donors. They include most of the public-serving nonprofits, both those that provide direct services (e.g., hospitals) and the federated funders (e.g., the United Way). Public charities generally spend a significant portion of the gifts they receive each year.

Private foundations, on the other hand, usually have only one or perhaps a few donors—usually one person, one company, or the members of a family. For example, the Bill and Melinda Gates Foundation was funded through gifts from Bill and Melinda Gates, and the Ford Foundation was created through gifts from Henry Ford. It is a common misunderstanding to think that the Gates Foundation was created by Microsoft Corporation. Indeed, the funds used to establish the foundation were those belonging to Bill and Melinda Gates personally. Likewise, the Ford Foundation was created by Henry Ford with his personal fortune, not by the Ford Motor Company.

Private foundations receive different tax treatment from public charities. One significant difference is that tax deductions allowed to individual donors for gifts to private foundations are more limited than for gifts to public charities. In addition, the investment earnings of private foundations are subject to a tax, and they face a requirement for minimum spending of their investment returns that does not apply to public charities. Indeed, what level of spending should be required of private foundations, and what should be included in the definition of that spending, has been a source of debate and legislation in recent years.
Supporting Organizations

Let's add yet another complication! There are organizations that use the word *foundation* in their name but are really public charities rather than private foundations. One type, community foundations, receive gifts from members of a particular community and make gifts to support a variety of service-providing nonprofits in that community. Another type of foundation that is a public charity is called, under the tax law, a *supporting organization*. These foundations are the fundraising arms of their host or parent organizations. They are public charities because they solicit and receive gifts from a large number of donors. But, unlike the United Way or community foundations, which make grants to multiple organizations, this type of foundation directs its support to just one organization. Such foundations are commonly associated with public universities. For example, the University of Maryland Foundation raises funds for the state university it serves. Some federal government entities also have affiliated foundations that seek private gifts to supplement the funds that the agency receives through public appropriations. An example of this is the National Park Foundation, a fundraising entity that supports the National Park Service. And, as in the case of the Sierra Club and The Sierra Club Foundation, there are foundations associated with nonprofit organizations that do not themselves qualify to receive tax-deductible contributions.

To complicate things yet further, there are private foundations that do not make any, or many, grants to other nonprofits and that may not even have the term *foundation* in their names. For example, Colonial Williamsburg, in Virginia, and Longwood Gardens, in Pennsylvania, are legally private foundations, but all their funds are used to support their own programs and operations. They are thus called *operating foundations* and, with some exceptions, are not sources of financial support for other nonprofits.

We will consider foundations again in Chapter 10 as part of our discussion on fundraising. Students who are interested in how foundations are managed will find many excellent resources, including books and the Web sites of the Council on Foundations (www.cof.org), the Forum of Regional Associations of Grantmakers (www.givingforum.org), and Grantmakers for Effective Organizations (www.geofunders.org), among others.

THE SPECTRUM OF ORGANIZATIONS

So far, we have looked at ways of differentiating nonprofit organizations according to their purposes and activities (the IRS classifications and the NTEE), according to who benefits from their activities (Salamon’s [1999] member-serving and public-serving categories), and according to their sources of support (public charities and private foundations). Yet another way to differentiate nonprofits is according to the degree in which they are commercialized—that is, the extent to which they operate like businesses.

In their 2001 book, *Enterprising Nonprofits: A Toolkit for Social Entrepreneurs*, Dees et al. depict a spectrum of nonprofit organizations (which they call “social enterprises”; see Table 1.1). Each endpoint of the spectrum represents an extreme—that is, a pure example of two alternate conditions. The spectrum encompasses every possible point in between. In Dees et al.’s spectrum, the two extremes are organizations that are “purely philanthropic” and those that are “purely commercial,” defined by their “general motives, methods, and goals” and their...
relationships with their key stakeholders. In other words, we might think of those at the left endpoint of the spectrum as the most nonprofit-like and those at the right endpoint as the most businesslike. In between, at various points along the spectrum between the two extremes, are most nonprofit organizations today.

Let’s walk through Dees et al.’s (2001) spectrum thinking about three organizations, including two we saw on our hypothetical tour of Washington, D.C., and a third that is

<table>
<thead>
<tr>
<th>General motives, methods, and goals</th>
<th>Continuum of Options</th>
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<tr>
<td>Purely Philanthropic</td>
<td>Hybrid</td>
</tr>
<tr>
<td>Appeal to goodwill</td>
<td>Appeal to mixed motives</td>
</tr>
<tr>
<td>Mission driven</td>
<td>Balance of mission and market</td>
</tr>
<tr>
<td>Goal is social value creation</td>
<td>Goal is social and economic value creation</td>
</tr>
</tbody>
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<table>
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<tr>
<th>Key stakeholders</th>
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<tbody>
<tr>
<td>Beneficiaries</td>
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<td>Sources of capital</td>
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<tr>
<td>Workforce</td>
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<td>Suppliers</td>
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Source: Adapted from Dees et al. (2001, p. 15). Used with permission of John Wiley & Sons, Inc.
familiar to all of us—Miriam’s Kitchen, The George Washington University, and Microsoft Corporation. Even Miriam’s, which is close to what most people would think of as a purely philanthropic nonprofit and thus somewhere close to the left end of the spectrum, is not entirely pure according to Dees et al.’s criteria because it does employ paid staff. But it is close enough to serve as an example for our discussion. Microsoft, most would agree, is close to a pure example of a commercial organization, at the right end of the spectrum. The George Washington University is somewhere in between—in Dees et al.’s terminology, it is a hybrid that is somewhat nonprofit-like and somewhat like a business. This is true of most private colleges and universities and, in some ways, increasingly true of public universities as well.

What characterizes organizations that are purely philanthropic? As Dees et al.’s chart indicates, such organizations appeal to goodwill rather than self-interest. People engage with Miriam’s Kitchen because they hold compassion and concern for homeless individuals. But few would buy Windows because Microsoft needs the money! What about universities? They appeal to mixed motives. People do feel altruistic about universities; that’s why many alumni continue to make gifts long after they have graduated. But, for most students, attendance at a university is also a practical investment. Although some may value learning for its own sake, most are likely motivated to study at least in part by self-interest—that is, an interest in their own financial futures.

Philanthropic organizations are mission driven. If they are purely philanthropic, then, at least theoretically, they pursue the mission without any regard for the financial bottom line. Although this image may comport with the stereotype that some may hold of nonprofits as organizations run by dedicated volunteers unconcerned with money, an example of that purest form would be somewhat difficult to find in today’s nonprofit world, for many of the reasons we already have discussed. On the other hand, Microsoft is unlikely to produce software that nobody wants to buy, regardless of what social value it might serve—it is, like all businesses, market driven. What about a university? Again, most are mixed, balancing commitment to a mission with responsiveness to the market. A university may continue to offer academic programs or to support research efforts that are not profitable, indeed, that require a subsidy, because they are important to its educational mission. But most universities also respond to the market, developing new programs and expanding others that are attracting increased student interest.

Philanthropic organizations are concerned with creating social value—in the simplest terms, with improving the lives of individuals and their communities; they are not about making money for its own sake. On the other hand, as we have discussed before, the principal goal of a business is to create economic value—in other words, to generate profits and increase its owners’ wealth. Again, the hybrids that Dees et al. (2001) define pay almost equal attention to both components of the double bottom line, focusing on the creation of both social and economic value, or in the words of Bill Shore (2001), they are “doing good by doing well.”

Let’s look at our three sample organizations’ relationships with some of their key stakeholders—their beneficiaries (clients), those who provide them with capital funds, their workforce, and their suppliers. At purely philanthropic organizations, clients pay nothing for the services they receive, like the hundreds of homeless men and women who are served by Miriam’s Kitchen. On the other end of the spectrum, people generally pay for their Microsoft software at whatever market price prevails. And hybrids? Let’s consider a typical undergraduate classroom in a private university. Some students will be attending on full
scholarships—they pay nothing in the way of tuition. Others, from more affluent families, may be paying the full tuition price listed in the university bulletin, while still others will be paying some portion of the listed tuition with scholarships to cover the rest. This is typical of hybrid nonprofits, including universities and hospitals, which often serve a mix of full payers and subsidized clients.

If Miriam’s needs capital to expand or meet special organizational needs, it will obtain it through fundraising for gifts or grants. Microsoft will issue new stock or borrow money, paying the full market rate of interest. Hybrids often mix these methods; for example, a university may have a campaign to raise capital dollars through gifts but may also borrow funds for the construction of new buildings. Nonprofits sometimes can borrow at less than the market rate of interest, although some will also borrow at the going market rate.

The purely philanthropic workforce is composed entirely of volunteers. As we have discussed, this is the case for some small nonprofits, although many (including Miriam’s Kitchen) have paid staff members in addition to a substantial volunteer workforce—they are not, in Dees et al.’s (2001) terminology, “pure.” But it is likely that no one volunteers at Microsoft. The company pays market wages and, indeed, competes in the marketplace for talent. Universities, as any professor will testify, are somewhere in between; professors do not work for free, but neither do they earn the salaries their talents might command in a purely commercial enterprise.

How do nonprofits obtain needed supplies? A purely philanthropic nonprofit would have all its supplies contributed; that is, it would receive them through gifts-in-kind. Miriam’s does receive such gifts, although it also purchases some of the food it needs for its breakfast program. However, it is doubtful that Microsoft ever receives such gifts, and it likely pays the market price for its pencils as well as its PCs (although it may negotiate some discounts based on volume rather than the generosity of its suppliers). As a hybrid, a university may receive some gifts in kind, pay market price for some products, and receive educational discounts on others.

Again, it is important to emphasize that the concept of a spectrum includes various points along the line rather than two or three discrete categories, so organizations may be hybrids to a lesser or greater extent. Indeed, the reality in today’s nonprofit sector is that relatively few organizations offer an example of the purely philanthropic as Dees et al.’s (2001) chart defines it. Most are hybrids to some degree. Even Miriam’s Kitchen. Most private universities are hybrids, commercialized to a considerable degree, and even state universities have moved in that direction, receiving a diminishing portion of their revenues from state funds and an increasing portion from tuition charges and gifts (Selingo, 2003).

Are there examples of purely commercial organizations? Microsoft may come pretty close, but some argue that, indeed, for-profit businesses are becoming more nonprofit-like. While many nonprofits demonstrate increasing degrees of commercialization—that is, they are moving from left to right across Dees et al.’s (2001) spectrum, many corporations are becoming more attuned to their social responsibilities, tempering their pursuit of profit at least somewhat with a concern for social value. In terms of Dees et al.’s spectrum, they may be moving to the left (no political pun intended!). Because of these movements in both directions across the spectrum, some see a blurring of the nonprofit and for-profit sectors. Some celebrate it, while for others it arouses deep concern.
COMMERICALIZATION CONTROVERSY

Commercialization of nonprofits is a source of controversy. Some observers view the increasing use of business methods in nonprofits and their efforts to develop streams of earned income to be desired, reducing their dependence on government and on gifts and increasing their effectiveness. In his influential 1999 book, *The Cathedral Within*, Bill Shore writes that nonprofits “forfeited the marketplace long ago, simply walked off the field . . . and chose instead to settle for the crumbs instead of the cake” (p. 205). He argues that nonprofits should begin businesses that generate revenue as a way to gain independence from philanthropic giving and government funds. “Redistributing wealth is not going to be enough,” Shore says. “Creating new [economic] wealth is the only course for nonprofits and community-based organizations struggling to meet social needs” (p. 208). Shore is the founder of the nonprofit Share Our Strength, an antihunger organization based in Washington, D.C. Consistent with his own advice, he also created Community Wealth Ventures, a for-profit subsidiary of Share Our Strength. Community Wealth Ventures earns revenue by advising nonprofits on how to start revenue-producing businesses and directs its profits to help support Share Our Strength’s programs.

But others express concern that the increasing commercialization of the nonprofit sector may eventually lead some organizations to put profit ahead of their social missions. For example, Burton Weisbrod (2004), an economist who was a pioneer in studying the nonprofit sector, cites the YMCA, which he says has “morphed into a health-and-fitness goliath” (p. 1, electronic version). Observing the YMCA’s increasing presence in upscale neighborhoods, where it competes with for-profit health clubs, Weisbrod questions whether it has strayed from its traditional mission of serving low-income families and asks “whether it has become overly commercialized and whether it [even] deserves tax-exempt status” (p. 3, electronic version). He advocates policies to limit the commercial activity of nonprofits while creating stronger tax incentives to encourage traditional charitable and philanthropic giving. Thus, the issue of commercialization is more than philosophical; it has implications for the continued tax-exempt status of some nonprofits.

Commercialization and Tax Exemption

A companion to the common misunderstanding that nonprofit organizations cannot earn profits is the misunderstanding that nonprofits are *always* exempt from taxation. They are exempt from income taxation on revenues related to their social missions, but revenues from activities that are not related to the mission are subject to the unrelated business income tax (UBIT). An activity is unrelated and subject to this tax if it meets three requirements: (1) it is a trade or business, as defined by the IRS; (2) it is regularly carried on; and (3) it is not substantially related to the exempt purpose of the organization. The definition of “substantially related” is provided by the IRS (2005a), with characteristic clarity:

To determine if a business activity is “substantially related” requires examining the relationship between the activities that generate income and the accomplishment of the organization’s exempt purpose. Trade or business is related to exempt purposes, in the statutory sense, only when the conduct of the business activities
has causal relationship to achieving exempt purposes (other than through the production of income). The causal relationship must be substantial. The activities that generate the income must contribute importantly to accomplishing the organization’s exempt purposes to be substantially related.

Activities carried out by volunteers; a trade or business carried out for what IRS calls the “convenience” of clients or members; and sales of donated merchandise, for example, in a thrift shop, are specifically excluded from UBIT. So, for example, universities are not taxed on revenue from dining halls or other food operations since these services are provided for the convenience of students (although it may surprise students to learn this)!

Most business activities undertaken by nonprofits are related to the mission, and the revenues generated are therefore not taxable. For example, a nonprofit that develops a business to employ individuals with disabilities is serving its mission of providing job training and rehabilitation, even though the services it provides may generate substantial revenue and even compete with the services provided by for-profit companies. But the line is not always clear. For example, one area of dispute has been gift shops operated by museums. If an art museum gift shop sells products that include reproductions of paintings in its exhibits, that could be related to its mission of educating and informing the public about art. But sales of products that are not related to the museum’s collections might be regarded as unrelated and subject to the UBIT (IRS, 2005b).

One concern is that unrelated business activities not become a substantial part of the organization’s activities. If they do—in general, if the amount of the nonprofit’s time and resources devoted to the business activity exceeds that devoted to its mission, it is in danger of having its tax exemption revoked. The issue of related and unrelated income is far from settled and is often an area of dispute between nonprofits and the IRS. In subsectors where commercialization has advanced the most—for example, health services, the tax exemption of institutions is a topic of continuing political debate. In other words, as a nonprofit becomes more like a commercial enterprise, moving as it were from left to right across Dees et al.’s (2001) spectrum, there could come a point at which it will be deemed to have crossed over the line, ceasing to be a nonprofit at all.

**Implications for Nonprofit Managers**

What are the implications of increasing commercialization, the blurring of the sectors, and related policy debates for the practice of nonprofit management? Today’s nonprofit sector requires that managers be somewhat hybrids themselves. They must combine a commitment to their organization’s nonprofit mission with business skills, to manage the double bottom line. They must hold an appreciation for the nonprofit sector’s unique history and traditions while also understanding how to succeed in a competitive marketplace. They must be able to adapt to the social and political forces affecting their organizations while also preserving the core values and defending the special status of their organizations. In other words, as we said in the Introduction to this book, nonprofit management requires a unique blend of skills, distinguishing it from management in government or the for-profit sector. And current trends suggest that the task will not become less challenging in the years ahead.
CHAPTER SUMMARY

America’s nonprofit sector is large and diverse. Its roots lie in the ancient traditions of charity, philanthropy, and voluntarism; voluntary efforts were prominent in the nation’s early days. But the sector’s modern form is a product of 20th-century history and especially the period since the 1970s. Although nonprofit organization and nonprofit sector are the terms most commonly used, others have proposed a variety of alternative names for the sector.

The nonprofit sector is large and growing, including about 400,000 member-serving and about 1,200,000 public-serving organizations. Organizations may be placed in categories according to the tax-exempt classifications used by the IRS or the more elaborated NTEE, both of which determine categories based on organizations’ principal activities. Most organizations registered with the IRS fall into two classifications. “Charitable nonprofits” are both exempt from taxation under Section 501 (c) (3) of the IRC and also eligible to receive tax-deductible gifts from individuals and other donors. “Social welfare organizations” are tax-exempt under Section 501 (c) (4), but gifts to them are not tax deductible, since they are not limited in their expenditures on lobbying activities.

Most nonprofit organizations are small, but in terms of revenues and employment the sector is dominated by five subsectors: health care, education and research, social and legal services, religion, and art and culture. The subsectors show significant differences in their sources of revenue and the extent to which their management has been professionalized.

Many nonprofits today are said to be hybrids. They are not purely philanthropic or purely commercial but fall somewhere on a spectrum between those two extreme cases. This is because they demonstrate a mixture of philanthropic and commercial motives, methods, and goals, and their relationships with their stakeholders demonstrate a mix of philanthropic and business characteristics. Many nonprofits have become more commercial at the same time as some businesses are expressing more concern about social goals. This blurring of the sectors pleases some and concerns others, who fear that nonprofits will drift away from their social missions. In this environment, nonprofit management requires a unique combination of commitment, knowledge, and skills.

NOTES

1. Beginning in 2008, small nonprofits that are not required to file Form 990 will nevertheless be required to file a brief Form 990-N, also known as the “e-postcard” (www.irs.gov, accessed December 5, 2007).
2. The terms nonprofit and tax-exempt are not strictly synonymous, since there are some for-profit entities—for example, certain partnerships—that are also not required to pay income tax and there are organizations that are required to pay taxes but do not distribute profits to owners (Hopkins, 2005, p. 30).
3. It is a fine but important distinction to understand that the IRS does not “grant” tax exemption to nonprofit organizations. If they meet appropriate criteria, they are tax-exempt under the law. The IRS merely “recognizes” that status conferred by the law (Hopkins, 2005).
4. Although we do not focus on member-serving organizations in this book, students who are interested will find a rich array of resources, including those available through the American Society of Association Executives (www.asaenet.org), a professional association comprising trade and professional association managers, based in Washington, D.C.
5. There is a distinction between churches, synagogues, and mosques and nonprofit organizations that are faith based but provide social services to their communities without regard to religious affiliation.

**KEY TERMS AND CONCEPTS FROM CHAPTER 1**

- charitable choice
- charitable nonprofits
- charity
- civil society
- hybrid organization
- Independent Sector
- institutionally related foundations
- member-serving organizations
- National Taxonomy of Exempt Entities (NTEE)
- nongovernmental organizations
- operating foundations
- philanthropy
- private foundation
- public charity
- public-serving organizations
- social enterprise
- social welfare organizations
- supporting organization
- tax deductible
- tax-exempt
- voluntarism
- unrelated business income tax

**QUESTIONS FOR DISCUSSION**

1. If you had $25 to give today to any nonprofit organization, which one would it be? Now, imagine that you are 75 years old and have $1,000,000 to give to an organization on your death—that is, through your will. Which one would it be? Do your answers reflect a difference between charity and philanthropy?

2. If you were the president of a private college or university, what things would you consider in making a decision on a possible tuition increase, which might enhance your bottom line but possibly work against your mission of providing educational opportunity?

3. Should gifts made by individuals to a nonprofit organization that receives the largest portion of its revenues from fees for services be fully tax deductible, partially tax deductible, or not deductible at all? Why or why not?

4. Suppose a nonprofit organization operates a business that is related to its mission, such that revenue is not subject to the UBIT, but it competes directly with a for-profit business nearby that must pay taxes. (Think of the nonprofit jazz club HR-57, which exists on the same street as for-profit bars and clubs.) Is that unfair competition with the for-profit businesses, and should the nonprofit be taxed just to level the playing field? Why or why not?

5. Is nonprofit management best taught in business schools; in schools of public affairs; or in some other school, department, or program of the university?
SUGGESTIONS FOR FURTHER READING RELATED TO CHAPTER 1

Books


Web Sites


Independent Sector, www.independentsector.org

Urban Institute Center on Nonprofits and Philanthropy, www.urban.org/content/PolicyCenters/NonprofitsandPhilanthropy/Overview.htm