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# ECONOMIC PERSPECTIVES ON REGULATION OF CHARITABLE SOLICITATION

*Richard Steinberg\**

REPORTS of fraudulent solicitations involving charitable institutions permeate the news.<sup>1</sup> Spurred on by these reports, as well as reports of self-dealing, inefficiency, and excess in charitable solicitations, numerous states have acted to regulate charitable solicitations.<sup>2</sup> Congress has also considered regulating charitable solicitations in order to control these irregularities.<sup>3</sup> Because prosecution for fraudulent solicitation is difficult under existing laws,<sup>4</sup>

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1. See, e.g., Evans, *Alexandria Firm Accused of Fraud*, Wash. Post, Jan. 14, 1989, at A13, col. 1 (Virginia direct-mail firm accused by Missouri Attorney General of fraud and deception in fundraising letters it sent on behalf of its client charities); Garcia, *State Conducting Probe of Two Charities*, L.A. Times, Dec. 28, 1988, part 2, at 3, col. 4 (California Attorney General investigates national direct-mail campaign offering sweepstakes award to potential donors).

2. *State Laws Regulating Charitable Solicitations*, GIVING USA UPDATE, Jan.-Feb. 1988, at 4, 4-10 (table listing state law restrictions on charitable solicitations as of Dec. 31, 1987). See generally *Keeping Up With the States* in PHILANTHROPY MONTHLY (a standing column discussing the effects of changing state laws which regulate charitable contributions); e.g., Stevenson, *Keeping Up With the States*, PHILANTHROPY MONTHLY, Feb. 1986, at 25, 25 (discussing the Pennsylvania legislature's proposed law that would limit solicitations to institutions in which solicitation and fundraising expenses do not exceed 35% of actual contributions received).

3. See, e.g., H.R. 2188, 100th Cong., 1st Sess., 133 CONG. REC. H2638 (daily ed. Apr. 28, 1987) (proposing amendments to Internal Revenue Code which would require certain charities which solicit contributions from the public to use at least 50% of gross receipts for charitable purposes); H.R. 2130, 100th Cong., 1st Sess., 133 CONG. REC. H2132 (daily ed. Apr. 22, 1987) (requiring disclosure of certain information in connection with the solicitation of charitable contributions by mail). But see *Two Curious Case Histories of Proposed Legislation in Congress to Regulate Charities and Mail Fund Raising*, PHILANTHROPY MONTHLY, May 1987, at 20 (suggesting that the motive for introducing this legislation was political rather than concern about fraud in charitable solicitations).

4. The problem with prosecution under traditional fraud theories is that charities can use creative accounting to hide many fraudulent acts. Even if the accounting numbers are accurate other problems persist. For instance, the lack of an upper limit defining when the proportion of expenses to charitable contributions rises to the level of fraud creates uncer-

legislators have recently experimented with a new approach which involves restricting the allowable fundraising percentage.<sup>5</sup>

This area of the law has also attracted the attention of the courts. In *Village of Schaumburg v. Citizens for a Better Environment*, the Supreme Court held that charitable solicitations are within the protection of the first amendment.<sup>6</sup> This protection forces a state to demonstrate that the statute "serves a sufficiently strong, subordinating interest that the [state] is entitled to protect"<sup>7</sup> and that the statute is a "narrowly drawn regulation designed to serve those interests without unnecessarily interfering with First Amendment freedoms."<sup>8</sup> Applying this test, the Supreme Court has consistently found that restrictions on fundrais-

tain results. Compounding the difficulty of fraud prosecution are the evidentiary problems of prosecuting telephone solicitors who often use false names and the limited manpower allocated by the states to this problem. *Conversations on Fund Raising Law Reform*, PHILANTHROPY MONTHLY, Feb. 1986, at 29, 32-34 (comments of Mr. Kevin Suffern, Director of the Division of Public Charities of Massachusetts, Assistant Attorney General of Massachusetts, and co-chairman of the National Model Law Project).

5. A charity's fundraising percentage equals the expenses of solicitation divided by the total funds raised by solicitation. Illinois used this definition in the following legislation:

Where less than 75% of the gross receipts, excluding any bequests or gifts by will or other testamentary device, of such charitable organization . . . are used for charitable purposes. . . . [The Attorney General] may bring . . . an action in the name, and on behalf of the people of the State of Illinois against such charitable organization and any other person who has participated . . . in such solicitation . . . .

ILL. REV. STAT. ch. 23, para. 5109(c) (1987). The Illinois statute defines "gross receipts" as "receipts after the legitimate and reasonable cost of any merchandise for resale or the legitimate and reasonable cost of services required with the fund raising event or program are deducted." *Id.*

6. *Village of Schaumburg v. Citizens for a Better Env't*, 444 U.S. 620, 632 (1980). *Accord* *Riley v. National Fed'n of the Blind*, 108 S. Ct. 2667, 2673 (1988); *Maryland v. Joseph H. Munson, Co.*, 467 U.S. 947, 959-60 (1984). *See also* *New York Times v. Sullivan*, 376 U.S. 254, 266 (1964) (holding that a newspaper advertisement which solicited funds was protected by the first amendment).

In *Schaumburg*, the Court stated:

[C]haritable appeals for funds, on the street or door to door, involve a variety of speech interests — communication of information, the dissemination and propagation of views and ideas, and the advocacy of causes — that are within the protection of the First Amendment. Soliciting financial support is undoubtedly subject to reasonable regulation but the latter must be undertaken with due regard for the reality that solicitation is characteristically intertwined with informative and perhaps persuasive speech seeking support for particular causes or for particular views on economic, political, or social issues, and for the reality that without solicitation the flow of such information and advocacy would likely cease.

444 U.S. at 632.

7. *Schaumburg*, 444 U.S. at 636. *Accord* *Munson*, 467 U.S. at 961.

8. *Schaumburg*, 444 U.S. at 637. *Accord* *Munson*, 467 U.S. at 961.

ing percentages purporting to attack fraud in charitable solicitations are unconstitutionally broad<sup>9</sup> because "there is no nexus between the percentage of funds retained by the fundraiser and the likelihood that the solicitation is fraudulent."<sup>10</sup>

Chief Justice Rehnquist offers an opposing view. He uses a commercial speech analysis which allows restrictions on the fundraising percentages of professional fundraisers as long as these restrictions are narrowly tailored.<sup>11</sup> These limitations are useful, he

9. "Our prior cases teach that the solicitation of charitable contributions is protected speech, and that using percentages to decide the legality of the fundraiser's fee is not narrowly tailored to the State's interest of preventing fraud." *Riley*, 108 S. Ct. at 2673., *Accord Munson*, 467 U.S. at 966-68; *Schaumburg*, 444 U.S. at 636-37.

In *Schaumburg*, the Court distinguished the case before it from *National Found. v. City of Fort Worth*, 415 F.2d 41 (5th Cir. 1969), cert. denied, 396 U.S. 1040 (1970). In the latter case, the federal court of appeals upheld an ordinance which limited the cost of charitable solicitations within the city to 20% of the amount collected. The *Schaumburg* Court noted that Fort Worth's provision allowed an administrator to waive the 20% requirement if the solicitor could show the expense was reasonable. *Schaumburg*, 444 U.S. at 627-28. Legislators have since tried unsuccessfully to adapt their percentage-based limitations to meet the *National Foundation* exception. After *Riley*, however, any reliance on *National Foundation* may be ill-founded. In *Riley*, the Supreme Court invalidated a statute which allowed solicitors to overcome the percentage requirement by showing the reasonableness of the solicitation costs. The statute was held constitutionally invalid because it placed the burden on the speaker to justify his speech rather than on the state to justify the limitation. *Riley*, 108 S. Ct. at 2674-75.

10. *Riley*, 108 S. Ct. at 2675. The majority of the Court feels that use of percentage based restrictions is capricious. In *Riley*, the Court stated:

[T]he use of a percentage based test was not narrowly tailored to achieve [the] goal [of prevention of fraud]. In fact, we found that if the statute actually prevented fraud in some cases it would be "little more than fortuitous." An "equally likely" result would be that the law would "restrict First Amendment activity that results in high costs but is itself a part of the charity's goal or that is simply attributable to the fact that the charity's cause proves unpopular."

*Riley*, 108 S. Ct. at 2673 (quoting *Munson*, 467 U.S. at 966-67).

11. In his dissent to *Munson* (joined by Chief Justice Burger, and Justices Powell and O'Connor), Justice Rehnquist argued that a percentage restriction on payments to a professional fundraising firm "is merely an economic regulation controlling the fees the firm is permitted to charge. A similar regulation governing, for example, the fees charged by an employment agency would be judged and approved under the minimum rationality standard traditionally applied to economic regulations." *Munson*, 467 U.S. at 979 (Rehnquist, J., dissenting). In his dissent in *Riley* (joined by Justice O'Connor), Justice Rehnquist argued that "the Court obdurately refuses to allow the various States which have legislated in this area to distinguish between the sort of incidental fundraising involved in *Lovell*, *Schneider*, and *Martin* on the one hand, and the entirely commercial activities of people whose job is, simply put, figuring out how to raise money for charities." *Riley*, 108 S. Ct. at 2682 (Rehnquist, J., dissenting). In his dissent in *Schaumburg*, Justice Rehnquist stated:

Today's opinion strongly, and I believe correctly, implies that the result here would be otherwise if [the] primary objective [of Citizens for a Better Environment] were to provide "information about the characteristics and costs of goods

argues, because they prevent diversion of charitable solicitations for private financial gain.<sup>12</sup> Furthermore, percentage limitations help fulfill the expectations of the average contributor who expects the bulk of his contribution to go directly to the charitable purpose he selected. Percentage limitations also prevent charities from being overcharged by professional fundraisers.<sup>13</sup> "The concern is not that someone may abscond to South America with the funds collected. Rather, a high fundraising fee itself betrays the expectations of the donor who thinks that his money will be used to benefit the charitable purpose in the name of which the money was solicited."<sup>14</sup> Chief Justice Rehnquist has found the percentage limitation statutes to be sufficiently narrowly tailored because he sees high solicitation expenses themselves as an evil which the state can regulate.

Accommodation of first amendment values requires statutes that are narrowly tailored. This standard forces legislatures to supply a clear and precise statement of the state's interest in regulation. The difference between the majority's rationale in *Schaumburg* and the rationale offered by Chief Justice Rehnquist is that Chief Justice Rehnquist uses a commercial speech standard. The

and services," [*Schaumburg*, 444 U.S. at 632 (majority opinion)] rather than to "advocate positions on matters of public concern." [*Id.* at 635]. Four years ago, however, the Court relied upon the supposed bankruptcy of this very distinction in overturning a prohibition on advertising by pharmacists. . . . This and other considerations led the Court in that case to conclude that "no line between publicly 'interesting' or 'important' commercial advertising and the opposite kind could ever be drawn."

*Schaumburg*, 444 U.S. at 642 (Rehnquist, J., dissenting)(citations omitted)(quoting Virginia Pharmacy Bd. v. Virginia Citizens Consumer Council, 425 U.S. 748, 764 (1976)).

12. Percentage limitations "insure that funds solicited from the public for a charitable purpose will not be excessively diverted to private pecuniary gain. In the process, they encourage the public to give by allowing the public to give with confidence that money designed for a charity will be spent on charitable purposes." *Munson*, 467 U.S. at 980 (Rehnquist, J., dissenting).

13.

There is an element of "fraud" in soliciting money "for" a charity when in reality that charity will see only a small fraction of the funds collected. But even if a fundraiser were to fully disclose to every donor that half of the money collected would be used for "expenses," so that there would be no question of "fraud" in the common-law sense of the word, the State's interest is not at an end. The Statute . . . is also directed against the incurring of excessive costs in charitable solicitation even where the costs are fully disclosed to both potential donors and the charity. Such a law protects the charities themselves from being overcharged by unscrupulous professional fundraisers.

*Munson*, 467 U.S. at 980 (footnote omitted)(Rehnquist, J., dissenting).

14. *Munson*, 467 U.S. at 980 n.2 (Rehnquist, J., dissenting).

current majority sees no necessary connection between percentage limitations and fraud. The validity of that assertion requires a basic understanding of what the contributor was trying to accomplish in addition to an assessment of the charity's objectives.

The following analysis is intended to assist legislators in identifying legitimate state interests more precisely and in designing statutes which will survive constitutional scrutiny. Sections I and II consider the diversity of donor and donee objectives as well as precisely when these donors and donees have cause to feel defrauded. Section III considers regulatory rationales based on society's broader interests. Section IV argues, consistent with the majority view in *Schaumburg*, that fund raising limitations generally fail to accomplish any of these legitimate state interests. Section IV concludes by suggesting alternative regulatory instruments which are better tailored to meeting these goals.

## I. THE DONOR PERSPECTIVE

The Supreme Court has ruled that statutes mandating a low fundraising percentage do little to protect the donor's interests. Chief Justice Rehnquist's view notwithstanding, the Court's position is correct for several reasons. For instance, donors may support charitable goals which can only be accomplished with a high fundraising percentage.<sup>15</sup> In addition, there is nothing in the percentage limitation that prevents a dishonest organization from misdirecting funds.<sup>16</sup>

There are two deeper reasons why fundraising percentage is not a valid indicator of fraud against donors. First, donor interests are often broader than charitable output alone. Second, the *average* fundraising share is itself a misleading statistic because it does not inform the donor as to the value of *incremental* donations.<sup>17</sup>

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15. These goals can be accomplished by "organizations whose primary purpose is not to provide money or services for the poor . . . but to gather and disseminate information about and advocate positions on matters of public concern." *Schaumburg*, 444 U.S. at 635. *Accord Riley*, 108 S. Ct. at 2675; *Munson*, 467 U.S. at 963-64.

16. *Munson*, 467 U.S. at 967.

17. The fundraising percentage at each level of donation is different. As the total donations increase, the percentage of funds spent on expenses will decrease because certain fixed costs will have been paid completely by earlier donations. In this way, although the average fundraising percentage is high (i.e., more money for expenses), the *incremental fundraising percentage* after fixed costs have been paid may be low (i.e., more money to the charity). The later contributor may feel that he is getting a higher value for his charity

### A. Donor Interests

Donors support many different charitable activities. In supporting charities donors often engage in the legitimate purchase of goods and services.<sup>18</sup> Charities frequently offer an explicit good or service along with the opportunity to make donations. Apparently, many donors find that a dinner, special event, or dedication ceremony complements their desire to make a donation.<sup>19</sup> Such events are a cost of fundraising; they provide incentives which may increase the volume of donations. The donor, in these circumstances, is not defrauded by a low fundraising percentage because she receives an explicit private good in addition to the incremental charitable output.<sup>20</sup>

A donor may also have goals other than charitable output maximization. For example, purchasers of Girl Scout cookies are frequently more concerned with the happiness of the soliciting child than the incremental monetary resources provided to the organization. These donors probably would not feel cheated if the fundraising percentage were low. Contributors to United Way might be lumped into this same class as well, because "[t]he expected benefits . . . are in the form of goodwill in response to social pressure, rather than estimation of personal gain from services provided by United Way."<sup>21</sup> State laws which restrict fundraising

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dollar because the percentage of his donation which goes to expenses is low. This may encourage donors to contribute to a charity after initial fundraising expenses are paid.

18. This was recognized in *Riley*, 108 S. Ct. at 2679, in which the court stated, "[d]onors are undoubtedly aware that solicitations incur costs, to which part of their donation might apply."

19. See generally Nielsen, *Piggybacking Strategies for Nonprofits: A Shared Costs Approach*, 7 STRATEGIC MGMT. J. 201, 201 (1986)(presenting "case data and a conceptual foundation for nonprofit piggybacking whereby a nonprofit organization subsidizes its deficit producing primary mission by diversifying into related surplus-producing ventures"); Posnett & Sandler, 14 PUB. FIN. Q. 209, 220 (1986)(arguing that "joint supply, in which a private good is supplied in circumstances in which surplus revenues are directed to finance a public output, is one possible explanation of why large fund-raising charities are successful").

20. Indeed, donors must reduce their tax deduction for charitable contributions by the value of anything received in exchange for the contribution. M. CHIRELSTEIN, FEDERAL INCOME TAXATION, A LAW STUDENT'S GUIDE TO THE LEADING CASES AND CONCEPTS 147 (1985). See also Treas. Reg. § 1.170A-4(c)(2)(iii) (as amended in 1982).

21. Keating, Pitts & Appel, *United Way Contributions: Coercion, Charity or Economic Self-Interest?*, 47 S. ECON. J. 816, 816 (1981)(providing statistical evidence in support of this hypothesis). See also Long, *Social Pressure and Contributions to Health Charities*, 28 PUB. CHOICE 55, 66 (1976)(statistical support for "the hypothesis that social pressure affects the level of charitable contributions" but "that the form of the pressure is an important determinant of the size of health contributions"); Steinberg, *Nonprofit Orga-*

percentage needlessly frustrate these classes of donors, since the satisfaction they derive from making a donation bears little relation to the charitable output of the donee.

### B. The Fundraising Percentage

For those donors who are concerned *only* with charitable output, a charity with a high fundraising percentage might appear to be a bad buy. Donors who are not informed of the percentage would appear to be defrauded. Donors who are informed but choose to donate anyway would appear to need protection from their own follies.

Intuition indicates that a high fundraising percentage translates into a lower amount of charitable output per donated dollar. This intuition is wrong.<sup>22</sup> *Incremental* resources provided for charitable service are unrelated to the *average* fundraising share.<sup>23</sup> A donor should not feel personally defrauded by a high average fundraising percentage if the incremental effect of his donation on charitable output remains high.<sup>24</sup>

A simple example illustrates this point. Suppose someone made a donation to a charity which always spends \$10,000 per year on solicitation and devotes all other resources to the provision of services. The charity receives \$1,000 per year in royalty income. Near the end of the year, \$9,000 in donations have been raised, so that the average fundraising share exceeds 100% and the charity is unable to provide any services. Despite the excessive fundraising percentage in this example, one hundred percent of the incremental donations made at this point would be devoted to providing services, and the charity would be a very good buy for the donor.

This situation will arise in a nonprofit which maintains a solicitation budget independent of its fundraising receipts. In such charities, donations are first used to offset the expense of fundraising. This point is important because a nonprofit may respond to incremental donations either by decreasing the solicitation budget

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*nizations and the Market*, in *THE NONPROFIT SECTOR* 118, 121 (W. Powell ed. 1987)(arguing that "Donors often make implicit trades, obtaining direct benefits . . ., indirect benefits . . ., and Kantian benefits . . .").

22. See Steinberg, *Should Donors Care about Fundraising?*, in *THE ECONOMICS OF NONPROFIT INSTITUTIONS: STUDIES IN STRUCTURE AND POLICY* 347, 347 (S. Rose-Ackerman ed. 1986)[hereinafter Steinberg, *Donors*].

23. *Id.* at 355-56.

24. *Id.* at 361.

or by increasing it.<sup>25</sup> The incremental effects on charitable output of a donation thus depend on the objectives of the donee.

A "service maximizer" is a donee who sets the solicitation budget so as to maximize the expected *net* returns from fundraising. This is achieved when a one-dollar increase in the solicitation budget is expected to yield exactly one dollar of additional donations. If the anticipated incremental returns exceed one dollar, the firm could increase its net receipts by increasing the solicitation budget until diminishing returns set in and further net gains become impossible.<sup>26</sup>

A "budget maximizer" cares only about the total returns from fundraising. Such a firm would devote an additional dollar to fundraising so long as any increase in donations, even one penny, was expected. Every penny of donations would increase the size of the overall budget, and budget maximizers are indifferent to whether these resources are devoted to service or solicitation efforts. Thus, the incremental *net* returns are negative at the solicitation budget level selected. Fundraising by budget maximizers is excessive in the sense that a decrease in the solicitation budget could actually increase service expenditures.<sup>27</sup>

Despite this excess, budget maximizers are no different than service maximizers from the donor's perspective, because either goal would lead the firm to select a solicitation budget which is independent of actual incremental donations. If the firm receives an extra dollar of donations, this would not affect the *prospective* returns on additional spending for solicitation. Thus, neither budget nor service maximizers are likely to adjust their fundraising budget in response to incremental donations. As in the example, once the solicitation expenses have been offset, the "cost" of a dollar's incremental service provision is exactly one dollar, since the incremental dollars received thereafter go entirely to service provision.<sup>28</sup>

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25. The solicitation budget would be cut if increased donations convinced the board that a less ambitious effort could accommodate their needs. Alternatively, the board might view incremental donations as a sign that they had underestimated their fundraising potential; in response they might increase solicitation efforts.

26. It is reasonable to assume that the incremental returns per dollar of fundraising expenditure eventually diminish. When they become less than one dollar, further expenditures yield *negative* returns.

27. Reducing the solicitation budget would eliminate some of the negative incremental net returns, thereby releasing funds from fundraising to provide charitable output instead.

28. Technically, this is true only for "small" incremental donations in the sense that

The situation is more complicated if the nonprofit decides to adjust its solicitation budget in direct response to incremental donations. When this occurs, the change in the budget induces a change in donations which induces a further change in the budget, *ad infinitum*. Thus, the impact of an incremental donation may be multiplied if the charity responds to increased donations by increasing solicitation in a range where the net returns to solicitation are positive. The same result occurs if the charity responds by decreasing solicitations in a range where the net returns are negative.<sup>29</sup> Also, the impact of an incremental donation may be multiplied or diminished due to feedback effects on other donors.<sup>30</sup>

Feedback effects cause an additional complication when there are multiple donees. In deciding whether to make an incremental donation to a given charity, a donor might consider the "cross-donative" effects of the donations of others on related charities. The donor gains little if a donation to a cancer research institute, for example, induces other donors to shift allegiances to other institutes without increasing the overall level of cancer research support. Alternatively, if a contribution to the Democratic Party, for example, not only increases donations by others but also reduces donations to the Republican Party, the personal return to donating would be magnified.

A donor has reason to feel defrauded if *incremental* donations are diverted from *incremental* service provision. This occurs if a fixed percentage of the net receipts of the campaign inure to the benefit of any individual. For example, the manager of the charity might covertly convert the entire net proceeds to his personal use. It is for this reason that some statutes regulate fundraising indirectly, by mandating a minimum expenditure on program rather than a maximum expenditure on solicitation. When these statutes include salaries as a program expenditure, abuse goes unchecked. When these statutes exclude salaries, however, they are overly broad, since fraud does not always accompany the payment of salaries to a charity's personnel.

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the response of other donors to solicitation is independent of the donation under discussion. In light of a major, well-publicized donation, other donors may feel the need for their own donations to be reduced, and thus be less responsive to solicitation efforts. Alternatively, they may "join the bandwagon," increasing the donee's returns for each level of fundraising expenditure. The relevant "price" for large donations is derived in Steinberg. *Donors*, *supra* note 22.

29. See *supra* notes 26-27 and accompanying text.

30. See *supra* note 28.

This situation is more complex when less than one hundred percent of the net proceeds from solicitation inure to an individual. This situation arises if the manager of the charity receives a profit-sharing type bonus or if the charity contracts with a professional fundraiser on a contingency or percentage basis. In these cases, the donor may consider the diversion of funds to be a good thing, because it induces a higher level of entrepreneurial effort that can improve the quality and quantity of service provision. However, if the incremental effect of a particular donation on entrepreneurial effort is negligible, the diversion of these incremental donations may be objectionable to that donor. This holds true even if society benefits from improved managerial effort induced by sharing earlier donations with the manager of the charity.<sup>31</sup>

Regulation of fundraising is an indirect way of getting at this problem because inurement is a separable issue. State nonprofit incorporation laws generally restrict the nonprofit form to organizations which disallow all private inurement.<sup>32</sup> In addition, a charity's federal corporate tax exemption may be denied due to this sort of inurement.<sup>33</sup> While the adequacy of the various state approaches remains unclear, they do seem to be more narrowly tai-

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31. This is precisely the conclusion of a more formal model developed in Steinberg, *Optimal Contracts Need Not be Contingent: The Case of Nonprofit Firms*, in *MODELS OF HEALTH AND HUMAN SERVICES IN THE NONPROFIT SECTOR* 87 (D. Hyman & K. Parkum eds. 1985) [hereinafter Steinberg, *Optimal Contracts*]. However, the model makes some rather restrictive assumptions to derive this conclusion, so its generality remains in doubt.

32. See Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 501-02 (1981).

33. Exemption from the federal corporate income tax is provided only to those nonprofit organizations in which "no part of the net earnings . . . inures to the benefit of any private shareholder or individual." I.R.C. § 501(c)(3) (1986). This restriction has been interpreted as prohibiting profit-sharing plans. See Gen. Couns. Mem. 35,865 (June 21, 1974). See also *People of God Community v. Commissioner*, 75 T.C. 127 (1980) (payments to persons having a personal or private interest in the organization preclude tax-exempt status for the organization but payments to unrelated third parties do not); *Gemological Inst. of America v. Commissioner*, 17 T.C. 1604, *aff'd*, 212 F.2d 205 (9th Cir. 1954) (per curiam) (rejecting argument that payments to an individual were not part of net earnings but merely measured thereby). Exemption was not denied, however, when a percentage-based fee was paid to a hospital radiologist who did not control the organization. Rev. Rul. 69-383, 1969-2 C.B. 113.

In 1980, the IRS seemingly reversed its policy of prohibiting "profit-sharing" plans outright. See Gen. Couns. Mem. 38,283 (Feb. 15, 1980). Lashbrooke summarizes the new developments and concludes: "The government is currently putting more emphasis on the significant benefit accruing to the employer's exempt purpose from incentive compensation than on the benefit derived by the employee. . . . It may only be a matter of time before tax exempt organizations can create qualified profit sharing plans to attract and retain quality employees." E. LASHBROOKE, *TAX EXEMPT ORGANIZATIONS* 165 (1985).

lored to the state's legitimate interest. Accordingly, statutes of this type should pass constitutional muster.

### C. Summary

The average fundraising percentage contains little information of value to individual donors for two reasons. First, the donor may care about outcomes other than induced service expenditures.<sup>34</sup> Second, the average-share statistic contains no information about the value of incremental donations. While society may care about the average return to donations, individuals can only control their increment to the donative pool. Thus, it is rational that they should care only about incremental returns from their individual donations. These incremental returns depend upon the behavioral reactions of the soliciting firm, multiplier effects on other donors, and cross-donative effects. Incremental returns do not depend on the average fundraising percentage. Unfortunately, it is not easy to measure incremental returns properly.

The average fundraising percentage is a simpler way for donors to "assess" the value of their donations. This method, however, has little to commend itself besides simplicity. As discussed above, donors might prefer charities with high fundraising percentages. Moreover, the development of incremental fundraising percentage statistics requires continuous oversight. If high-fundraising percentage charities are more carefully scrutinized by legal authorities and investigative reporters, the possibility of self-dealing behavior is lower.<sup>35</sup>

When a charity obligates itself, either behaviorally or contractually, to divert a fixed percentage of net receipts, this percentage is relevant information for the donor. Thus, a law mandating disclosure of fixed-percentage contracts seems appropriate. A court, however, might determine that such a law is overly broad because there are alternative methods available that are less intrusive. Disclosure upon donor request statutes, for instance, yield the same result.

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34. Of course, the incremental fundraising percentage would be of little value to the donor in this case since the donor's interest in the service output is limited.

35. Self-dealing is defined as "transactions wherein a trustee, acting for himself and also as 'trustee,' a relation which demands strict fidelity to others, seeks to consummate a deal wherein self-interest is opposed to duty." BLACK'S LAW DICTIONARY 707 (5th ed. 1983).

## II. THE DONEE PERSPECTIVE

Some states enact statutes that protect the interests of the donee charitable organization. Most often, it is professional fundraising firms which pose the perceived threat. In *Riley v. National Federation of the Blind*, the State of North Carolina claimed that contracts between charities and professional fundraising firms must be regulated to protect the interests of the charities themselves.<sup>36</sup> The Supreme Court rejected this claim. Writing for the majority, Justice Brennan argued:

there are several legitimate reasons why a charity might reject the State's overarching measure of a fundraising drive's legitimacy — the percentage of gross receipts remitted to the charity. For example, a charity might choose a particular type of fundraising drive, or a particular solicitor, expecting to receive a large sum as measured by total dollars rather than the percentage of dollars remitted. Or a solicitation may be designed to sacrifice short-term gains in order to achieve long-term, collateral, or non-cash benefits. To illustrate, a charity may choose to engage in the advocacy or dissemination of information during a solicitation, or may seek the introduction of the charity's officers to the philanthropic community during a special event (e.g., an awards dinner).<sup>37</sup>

A high fundraising percentage can result from a contract with a professional fundraiser or an entirely in-house operation. In either case, explanations other than incompetence or fraud, including sheer bad luck and the unpopularity of the cause, have been recognized.<sup>38</sup>

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36. *Riley v. National Fed'n of the Blind*, 108 S. Ct. 2667 (1988).

37. *Id.* at 2675.

38. The Supreme Court found in *Schaumburg* that there are: organizations whose primary purpose is not to provide money or services for the poor, the needy or other worthy objects of charity, but to gather and disseminate information about and advocate positions on matters of public concern. . . . Organizations of this kind, although they might pay only reasonable salaries, would necessarily spend more than 25 percent of their budgets on salaries and administrative expenses.

*Village of Schaumburg v. Citizens for a Better Env't*, 444 U.S. 620, 635 (1980).

The United States Court of Appeals for the Fifth Circuit, paraphrasing *Schaumburg*, noted that: "The realm of religious and charitable organizations . . . includes groups whose unorthodox messages will inevitably yield less cost-effective solicitation results. May [the local authorities] premise the simultaneous admission of, for example, evangelical Baptists and the exclusion of Krishna devotees on the results of their fund solicitation efforts?" *Fernandes v. Limmer*, 663 F.2d 619, 631 (5th Cir. 1981).

Additional factors bearing on cost-effective solicitation have been discussed by the

A charity can use statistical procedures to determine if it is accomplishing its goals via fundraising.<sup>39</sup> The essential data the charity needs is the incremental return to the last dollar spent on solicitation,<sup>40</sup> which is unrelated to the average fundraising percentage. In the simplest case, when donors are sensitive to fundraising expenditures but not to the fundraising percentage, a service-maximizing charity would select a budget leading to an expected incremental return of a dollar. On the other hand, a budget-maximizing charity would select a level leading to an incremental return of zero.

The statistical analysis should include other factors in measuring incremental returns. First, the charity should include the expected effect of current solicitation on future net returns. Apparently unproductive fundraising in the first few years of an organization's existence may allow the firm to weed out bad prospects from its donor base. These future returns may be attributed to start-up costs. Second, the charity should include the value of in-kind and volunteer labor donations as well as monetary returns. Finally, where the campaign produces both donations and an output which the charity cares about (such as public education), the value of such services should be added to the monetary returns in estimating the incremental value of solicitation.

An informed and voluntary decision by a charity to compensate its employees on a "profit-sharing" basis or to contract with a professional fundraiser on a percentage basis is not necessarily a wrong decision. Such contracts are rational when the gains to the charity due to enhanced effort outweigh the losses due to donor discouragement.<sup>41</sup>

When donors are sensitive to the fundraising percentage of

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commentators. See Miller, *Suggestions to Improve Private Standard Setting for Charities: The NCIB Proposals*, PHILANTHROPY MONTHLY, Nov. 1987, at 13; Quandt, *The Regulation of Charitable Fundraising and Spending Activities*, 1975 WIS. L. REV. 1158, 1178-79. For empirical evidence, see Boyle & Jacobs, *Fundraising Costs*, PHILANTHROPY MONTHLY, Apr. 1979, at 5.

39. See Steinberg, *Optimal Fundraising by Nonprofit Firms*, in 1985 SPRING RESEARCH FORUM WORKING PAPERS, GIVING AND VOLUNTEERING: NEW FRONTIERS OF KNOWLEDGE 411 (1985). See also Boyle & Jacobs, *The Economics of Charitable Fundraising*, PHILANTHROPY MONTHLY, May 1978, at 21; Cullis, Jones, & Thanassoulas, *Are Charities Efficient "Firms"? A Preliminary Test of the UK Charitable Sector*, 44 PUB. CHOICE 367 (1984); Weinberg, *Marketing Mix Decision Rules for Nonprofit Organizations*, 3 RES. MARKETING 191 (1980).

40. See *supra* notes 22-25 and accompanying text.

41. See Steinberg, *Optimal Contracts*, *supra* note 31, at 93.

charities not using incentive contracts,<sup>42</sup> the situation is more complicated. Despite donor sensitivity, the charity's goals are not generally accomplished by a zero fundraising percentage.<sup>43</sup> Thus, whether the charity's goal is budget or service maximization, the charity has not necessarily erred in choosing a high fundraising-percentage budget. This remains true even if an alternative budget would lead to a lower fundraising percentage.

In summary, the fundraising percentage is not useful for determining whether donees have been defrauded by professional fundraisers or erred in their internal campaigns. Donees care about incremental returns to solicitation (including lagged effects, non-monetary donations, and joint production of service), which are unrelated to average shares. This is so even when donors respond negatively to high fundraising percentages.

### III. THE SOCIAL PERSPECTIVE

In practice, the legitimate interests of donors may conflict with those of donees. In such cases, society as a whole has an interest in arbitrating the dispute. An example of this interest arises when a donor is concerned with service provision and the

42. While this Article argues that such behavior by donors is irrational (*see supra* notes 22-28 and accompanying text), the empirical evidence is mixed. One study concluded that donations are sensitive to fundraising levels but not to fundraising percentage. Steinberg, *Donors*, *supra* note 22, at 357. In contrast, Weisbrod and Dominguez have found that donors were significantly discouraged by a higher "price." The formula used to measure "price" was  $1/(1-x)$ , with  $x$  equal to the fundraising share in the previous year. Weisbrod & Dominguez, *Demand for Collective Goods in Private Nonprofit Markets: Can Fundraising Expenditures Help Overcome Free-Rider Behavior*, 30 J. PUB. ECON. 83, 94 (1986). Finally, Harvey and McCrohan found a significant positive relation between perceptions of efficiency and the size of donations. Harvey & McCrohan, *Fundraising Costs — Societal Implications for Philanthropies and Their Supporters*, 27 Bus. & Soc'y 15, 18 (1988).

43. The following example demonstrates this fact: Let  $C$  denote contributions,  $F$  solicitation expenses, and  $G$  the fundraising ratio  $F/C$ . Then, the service-maximizer's problem can be equivalently cast as picking  $G$  to maximize  $C - CG$  or  $C(1-G)$ .

It is reasonable to assume that  $C$  is a single-peaked function of  $G$ . When  $G$  is zero, contributions are low ( $F$  must be zero) but not zero (due to the reputation established through fundraising in previous years). An increase in  $G$  would first increase  $C$  (due to the direct effect of fundraising) then decrease it (due to donor dissatisfaction with high  $G$ ). The slope of the objective function is  $C'(1 - G) - C$  where  $C'$  denotes the slope of the contributions function. If this is negative around  $G = 0$ , optimal fundraising would be zero (since it is tedious but straightforward to show that the objective function is single-peaked). Otherwise, the optimum involves strictly positive  $G$ . Thus, donees would not want a zero fundraising ratio if  $C'(0)$  is larger than  $C(0)$ .

The assumptions about the  $C$  function directly imply that budget-maximizers would not want a zero fundraising percentage.

donee is a budget maximizer. While individual donors are not defrauded by budget maximizers, because one hundred percent of incremental donations are devoted to incremental service, donors as a class are hurt since a reduction in the donee's solicitation budget would increase the net proceeds available for service provision, making each member of the class better off. The question then becomes whether the collective interests of the donor class outweigh the interests of the recipient.

Economists generally analyze the social perspective in terms of the pareto standard.<sup>44</sup> A policy leads to a pareto improvement if no individuals are worse off (in their own estimation) and at least one is better off following the change. A related concept is the potential pareto standard. A policy leads to a potential pareto improvement when the gains to the winners (following adoption) outweigh the losses of the losers, so that a suitable redistribution would lead to an actual pareto improvement. An economy is said to be (socially) inefficient if a feasible policy not yet in use would lead to a potential pareto improvement.<sup>45</sup>

When the conflict between budget-maximizing donees and service-maximizing donors described above arises, the allocation may or may not be socially inefficient. Simplifying a bit, if the donee values the opportunity to engage in budget-maximizing behavior more than donors value the increment to service provision under alternative behavior, mutual gains are not possible.<sup>46</sup> Economists might nonetheless justify regulation by labelling budget-maximizing as a "merit bad" — a personal preference that society should not respect. In other words, society places a lower value on the activity than does the individual. However, economists have never developed ethically defensible standards by which they can determine whether a particular individual preference deserves the disrespect of social planners. The decision here must therefore be

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44. See generally H. ROSEN, PUBLIC FINANCE 42-45 (2d ed. 1988); J. STIGLITZ, ECONOMICS OF THE PUBLIC SECTOR 53-60 (1986).

45. For a discussion of the pareto standard in the context of welfare economics, see H. ROSEN, PUBLIC FINANCE 42-52 (2d ed. 1988); J. STIGLITZ, ECONOMICS OF THE PUBLIC SECTOR 52-63 (1986).

46. See H. ROSEN, PUBLIC FINANCE 42 (2d ed. 1988); J. STIGLITZ, ECONOMICS OF THE PUBLIC SECTOR 53-54 & 59-60 (1986). Mutual gains might be possible if the donor could transfer income to the budget maximizer directly. This would permit the nonprofit to have a slightly larger budget while spending less on fundraising and providing more service to the donors. Thus, inefficiency depends on whether the transaction costs of direct income transfers of this sort exceed the increment to fundraising expenditures resulting from budget-maximizing behavior.

made on non-economic grounds.

The social perspective is broader than just donor/donee conflict, because fundraising affects other members of society. A comprehensive analysis of the social efficiency of fundraising is beyond the scope of this Article. However, some examination of efficiency analysis is useful.

To begin with, we must understand why donors respond to solicitation efforts. If solicitation, as some allege about advertising, alters the donor's pure preferences, efficiency analysis is ill-defined. The donor may prefer his pre-solicitation allocation under his pre-solicitation preferences and prefer his post-solicitation allocation under his post-solicitation preferences. Thus, a meaningful determination as to whether the donor is better off in his own estimation cannot be made.

Ehrlich and Fisher's model of advertising provides an alternative which can be analyzed within the efficiency framework.<sup>47</sup> According to this model:

advertising affects the demand for goods because it lowers the gap between the market price received by the seller and the full price borne by the buyer — a gap that exists because of the buyer's cost of obtaining information about the characteristics of varieties of products and sellers, and the costs of adjusting to disappointing or imperfect purchases . . . .

[It is not necessary to construct] a positive theory of advertising, to determine whether the knowledge conveyed by sellers' messages is itself real or fancied, constructive or self-deluding by any objective standard.<sup>48</sup>

The possibility of fraudulent fundraising raises serious questions, however, about the simple application of efficiency analysis. This may be seen in an example suggested by Gordon Tullock: A donee alleges that the plight of starving children would be alleviated by contributions to his charity. However, the net proceeds from the fundraising campaign are used to finance his vacation. The uninformed donor will not discover the diversion of funds in the normal course of events. Other charities, by assumption, are not affected by this scam since the donor would not have contributed to them anyway.<sup>49</sup>

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47. Ehrlich & Fisher, *The Derived Demand for Advertising: A Theoretical and Empirical Investigation*, 72 AM. ECON. REV. 366, 367 (1982).

48. *Id.* at 366-67.

49. See Tullock, *Information Without Profit*, 1 PAPERS ON NON-MARKET DECISION

This scam is pareto-improving — the donor feels good about himself, the donee gets a nice vacation, and the starving millions are no worse off. Tullock does not suggest that this scam is a good thing; he infers, rather, that the pareto standard is ill-suited to judging cases of misinformation.<sup>50</sup> The matter deserves a great deal more thought.<sup>51</sup>

External effects of fundraising provide a more conventional source of inefficiency. An externality occurs when a market transaction affects agents who are not a party to that transaction. In the fundraising market, such externalities arise in two ways. The first example where externalities occur involves the situation wherein donations are used to finance public goods (goods, like national defense, that are consumable in a noncompetitive way). When this occurs, each donor is potentially affected by the solicitation of others. This externality has not been specifically addressed in the literature. The second example where externalities occur in the fundraising market arises where the productivity of solicitation expenditures by one donee is affected by the solicitation practices of other donees. This second effect has been analyzed, and is analogous to the well known tragedy of the commons.

Extension of the tragedy of the commons model to fundraising is straightforward, and allows the following conclusions to be drawn: When donees care only about their own net returns, fundraising by each charity is excessive; and if all charities reduced their own solicitation expenditures, each would experience an increase in net returns. Uncoordinated action by individual charities cannot accomplish this result. When only one charity reduces its solicitation expenditures, the benefit accrues only to other

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MAKING 141, 142 (1966), *reprinted in* G. TULLOCK, *THE ECONOMICS OF WEALTH AND POVERTY* 73, 74 (1986) (suggesting a similar example wherein the donee diverts the charity's funds to increase the utility of the donations).

50. *See id.* at 145, *reprinted in* G. TULLOCK, *THE ECONOMICS OF WEALTH AND POVERTY* 77 (1986).

51. A mechanism which increased the level of donor confidence in the result of their donation could be socially efficient. It might, however, be inefficient for the government to prosecute the wrongdoer after the scam has occurred. The donor would feel he had been victimized and would be worse off. The donee would go to prison and be worse off. The children would still starve. Prosecution would only be efficient if it deterred future misconduct to such an extent that increases in donor confidence outweighed current losses. This might make donors less confident about their donations even though the objective risk is lowered.

The most influential (but not the first or the most rigorous) exposition of this phenomenon is found in Hardin, *The Tragedy of the Commons*, 162 *Sci.* 1243 (1968).

charities.<sup>52</sup>

In the short run, two mechanisms may ameliorate this externality. First, donees might care about other donees and plan their campaigns accordingly. Second, donees might band together as a united fundraising organization (such as United Way), internalizing the externality by conducting a joint campaign and restricting member fundraising expenditures. However, neither mechanism solves the problem entirely. The first mechanism requires and relies upon a difficult calculation and sufficient altruism towards competing charities by each donee. The second mechanism is weakened by competition with nonmember charities. Membership will never approach one hundred percent because mainstream charities would fear the consequences of joining with controversial causes in a united campaign.

Susan Rose-Ackerman pointed out an additional problem that shows up in the long run. If new charities are formed to meet unmet needs whenever positive net returns to fundraising are available, the long run equilibrium appears to be massively inefficient.<sup>53</sup> Her formal model demonstrates that "competition for charitable dollars reduces the level of service provision relative to funds raised for all charities. In the absence of entry barriers, the number of charities increases until the fundraising share of the marginal charity approaches one. This result holds even if donors dislike high fundraising expenses."<sup>54</sup>

The real world situation is not as extreme as the formal model. Rose-Ackerman details several barriers to entry which keep us from attaining that long run equilibrium. Rose-Ackerman concludes, however, that there is no reason to suppose that these barriers are optimal.<sup>55</sup> Her conclusion establishes a prima facie case for government intervention.

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52. *Id.*

53. These new charities implicitly neglect the detrimental effect of their actions on the campaigns of established charities. See Rose-Ackerman, *United Charities: An Economic Analysis*, 28 PUB. POL'Y 323 (1980); see also Steinberg, *Nonprofit Organizations and the Market*, in THE NONPROFIT SECTOR 118, 125 (W. Powell ed. 1987). I say "appears" to be inefficient because fundraising is informative in the Rose-Ackerman model, yet she did not calculate the value of added information in the overentry equilibrium to determine whether it outweighed the loss in charitable services. Nonetheless, I suspect the inefficiency conclusion would hold in a more complete analysis. See Rose-Ackerman, *Charitable Giving and "Excessive" Fundraising*, 97 Q.J. ECON. 195 (1982)[hereinafter Rose-Ackerman, *Charitable Giving*].

54. Rose-Ackerman, *Charitable Giving*, *supra* note 53, at 205.

55. *Id.*

#### IV. REGULATION AND SOCIAL EFFICIENCY

Social inefficiency may arise when donees are budget maximizers or when there is over-entry in the market. This section considers three types of "remedies" — percentage limitations, mandatory disclosure, and entry barriers — and concludes that only entry barriers would have a positive effect on these social inefficiencies. Barriers to entry, however, may be more offensive to free speech rights than the first two options.

##### A. Percentage Limitations

Donors view solicitation by budget-maximizing donees as excessive. If the donor loss exceeds the donee gain, this behavior is socially inefficient as well.<sup>56</sup> A legal restriction on the absolute level of permissible solicitation expenditures is the natural solution to this problem. However, an effective program of this sort is not feasible. If legislation does not carefully consider individual donee circumstances, the law will inadvertently foster inefficiency in some service-maximizing firms. However, an inordinate amount of state resources would be necessary to assess the service-maximizing budget for each donee.

A variable ceiling on a donee's permissible fundraising percentage is less direct, but no less problematic. Although the fundraising percentage for some budget-maximizing charities might be lower than the corresponding percentage for some service maximizers, only the budget maximizers should be so regulated since the emphasis that service maximizers place on net returns makes regulation unnecessary. Again, the allowable percentage must vary with individual donee circumstances before any efficiency improvement occurs *vis-a-vis* budget maximizers. This would also require an inordinate amount of state resources.

A uniform ceiling on permissible fundraising percentage would help to solve the long-run problem of overentry. The allocation would also be efficient in that those charities that donors most want to support would survive, while charities serving less popular causes would be unable to meet this legal requirement. The essence of the free speech controversy, however, is that state regulations should not impair the operation of organizations simply because they are unpopular.<sup>57</sup> Such an impairment is the ultimate

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56. See *supra* note 46.

57. See *supra* note 10.

effect of a percentage limitation. The effect, however, is really a matter of degree — absent State regulation, only those causes sufficiently popular to obtain a positive net return can survive. State regulation does not throw a new roadblock on survival, it merely raises the height of an existing roadblock.

### B. Mandatory Disclosure

The second remedy, a mandatory disclosure law, appears at first to be unnecessary but harmless. A fraudulent answer to a prospective donor's inquiry would be difficult to prosecute even under a mandatory disclosure law, while a failure to answer would completely foreclose contribution. Therefore, a mandatory disclosure law would provide charities with an incentive that would increase rather than decrease the amount of fraudulent information in the marketplace. In addition, some donors may be too cynical to ask for a disclosure, certain that charities with something to hide would lie to them. These donors would not be any more likely to believe a compelled statement. The credibility of such disclosures might be enhanced if the government prosecuted *misrepresentation* more vigorously. This is quite different, however, from *nonrepresentation*.

Informational externalities complicate the analysis. If a newspaper reporter, for example, was unable to obtain information about a particular charity's fundraising practices, she would be less likely to publish a story about that charity. If the charity were forced to reveal unsavory practices, the reporter might publicize them, causing a major decline in donations. The prospect of this negative publicity would discourage the donee from engaging in unsavory practices in the first place. A disclosure on request law would obtain this advantage. A point-of-solicitation disclosure law would provide no additional advantage.

Most point-of-solicitation disclosure proposals mandate brief and objective disclosures such as past or anticipated fundraising percentages.<sup>58</sup> This information is not useful to donors, since the "price" of donations depends on complex factors which are diffi-

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58. See, e.g., H.R. 2130, 100th Cong., 1st Sess., 133 CONG. REC. H2132 (daily ed. Apr. 22, 1987)(describing a bill introduced by Representative Owens requiring mandatory disclosure). Cf. H.R. 2188, 100th Cong., 1st Sess., 133 CONG. REC. H2638 (daily ed. Apr. 18, 1987)(describing a bill introduced by Representative Swift of Washington mandating a minimum service expenditure percentage).

cult to measure.<sup>59</sup> However, even if a sophisticated donor desires point-of-solicitation disclosure for himself, he could still oppose disclosure as a social policy if he feels that other donors are likely to misinterpret the information *and* that the resulting loss in donations would outweigh the value of his own gain in information. Also, if a donor generally trusted charitable organizations he could oppose disclosure because the disclosed information would, if unrebutted, deter contributions. Moreover, the charity might successfully rebut disclosures that inhibit contributions, but only at a high cost. Under these circumstances, disclosure reduces the share of contributions devoted to service provision. Donors might not believe the added security provided by a mandatory disclosure law is worth this cost. A donee might also object to mandatory disclosure if donees, faced with the prospect of a loss in donations, would alter their behavior in a manner the donors regard as unfavorable. In particular, a disclosure might induce the donee to substitute fixed payments for percentage compensation schemes. This shift in contract form would reduce the fundraiser's incentive to work, possibly causing a decrease in donations that could be made available for service expenditures.<sup>60</sup>

Another problem with disclosure laws is caused by inter-donor externalities. Suppose, for example, that donors, persuaded by the analysis of donor "price," regard budget maximizers as good buys. In following their individual interests, however, they would ignore society's collective interest in discouraging donees from budget-maximizing behavior. It is possible (though by no means assured) that mandatory disclosure laws, by allowing donors to better perceive their individual interests, would lead donors to a greater neglect of their collective interests. Thus, donors as a class would be worse off.

### C. Barriers to Entry

The third option for state legislators is to impose explicit barriers to entry. One such barrier is a licensing law which would allow only donees possessing a license to solicit donations. Restricting the total number of licenses would eliminate overentry. Determining the optimum number of licenses, however, would be

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59. See *supra* note 42.

60. Conversation with Estelle James, Professor of Economics, State University of New York at Stonybrook (November 4, 1988).

quite difficult. As Susan Rose-Ackerman points out: "Although entry barriers permit positive levels of charitable services, they also reduce the ideological diversity of the nonprofit sector. The tradeoff between the variety and volume of services is a central policy dilemma."<sup>61</sup>

Another way to restrict entry is to issue and somehow allocate a limited number of marketable permits.<sup>62</sup> Solicitation without a permit would be illegal, but permits could be bought and sold on an open market. This system has the added advantage that those charities which donors most want to support would ultimately obtain permits, because the charity's willingness to pay for a permit would be governed by the potential net returns to fundraising. This allocation would occur automatically and flexibly, without any need for the state to know the potential fundraising productivity of individual charities. But this method has one unique disadvantage. Because the number of permits is limited, the state has created an asset whose value fluctuates according to market psychology. An organization, believing the price of permits would rise in the short run, might engage in arbitrage by purchasing more permits than it plans to use, hoping to sell them later at a gain. Such self-feeding speculation adds uncertainty to the market. Thus, the overall restrictiveness of a fixed quantity of permits would vary unpredictably.

A final barrier-type solution would be to mandate that all charitable solicitation take place through a united fundraising organization such as United Way. Rose-Ackerman analyzed this option, and concluded:

The fund economizes on fundraising costs both by reducing competition between existing charities and by making entry more difficult.

The benefits. . . are not costless, however. A federated drive may make it difficult for ideologically disparate charities to survive and may induce donors to purchase a package of charitable services that does not suit their ideologies.<sup>63</sup>

Each of these explicit entry barriers deals with the problem

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61. Rose-Ackerman, *Charitable Giving*, *supra* note 53.

62. The idea of a marketable permit as a solution to pollution problems was first proposed in J. DALES, *POLLUTION, PROPERTY, AND PRICES* (1968). I believe that I was the first to suggest its application to fundraising in my unpublished paper, "The Private and Social Efficiency of Fundraising by Nonprofit Organizations" (1982).

63. Rose-Ackerman, *Charitable Giving*, *supra* note 53, at 206.

of overentry more directly than restrictions on fundraising percentages. Yet, if percentage restrictions impermissibly intrude upon free speech rights, explicit entry barriers would seem to be even less permissible. These barriers are, however, explicitly focused upon legitimate state interests, so perhaps some future court, weighing the unavoidable conflict between individual and societal rights, will accept entry limitations.

#### CONCLUSION

Fraud may indeed be a problem, but neither regulation of fundraising percentage nor point-of-solicitation disclosure does much to stem fraud. Indeed, these regulations would stem fraud only by sheerest coincidence. Direct enforcement of anti-fraud and inurement statutes may be difficult, but it would be no coincidence if they succeeded.

The best reasons to regulate fundraising involve social inefficiencies. These stem from conflicts between donor and donee goals and from externalities among donors and donees. Simply put, a new charity lowers the potential net returns of fundraising for existing charities. There is a danger that new charities will enter until the net returns are driven to zero. Yet, any attempt to restrict entry of new charities, either implicitly (through maximum allowable fundraising share) or explicitly (through entry barriers) conflicts with the free speech rights of less popular causes. The tradeoff appears to be inherent, and the best compromise remains to be found.

