Deals

David Schizer

**Discussion Questions #5:**

**Nonprofits as Both Solution and Source of Information and Incentive Problems**

1. Review: Information Problems in High-Tech Startups
2. Arlene is an engineer who has an idea about how to make artificial intelligence more effective. If she pitches her idea to average investors, how effectively can they evaluate it?
3. Would it be easy to draft a detailed contract specifying exactly what Arlene should do at each stage of her work in developing her new approach to AI?
4. True or false: Instead of this sort of detailed contract, the VC industry structures deals—and, indeed, companies--in particular ways to address information problems and produce the right incentives. In other words, the industry uses organizations as a substitute for contracts.
5. Structuring as a Substitute for Contract at Nonprofits: The Nondistribution Constraint
6. True or false: Nonprofits also use organizational structure—though, admittedly, a different structure—to solve information and incentive problems.
7. The defining feature of a nonprofit is the “nondistribution constraint.” According is Henry Hansmann, who pioneered the study of the law and economics of nonprofits, a “nonprofit organization is, in essence, an organization that is barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees. By ‘net earnings’ I mean here pure profits-that is, earnings in excess of the amount needed to pay for services rendered to the organization.”
8. Are nonprofits barred from earning a profit?
9. Hansmann explained this nondistribution constraint–and, more generally, the justification for using nonprofits–as follows: “[O]ccasionally, due either to the circumstances under which the product is purchased and consumed or to the nature of the product itself, consumers may be incapable of accurately evaluating the goods promised or delivered. . . . In situations of this type, consumers might be considerably better off if they deal with nonprofit producers rather than with for-profit producers.
10. What kind of problem is Hansmann invoking to explain why nonprofits are used? How does his point connect to the main themes of this course?
11. Why is the nondistribution constraint a potential solution?
12. First Type of Information Problem: Expertise
13. Ben has serious back pain. He has no medical training.
    1. How effective is he personally in analyzing the diagnosis he receives from a surgeon that he needs surgery?
    2. Does this help explain why the oldest and most prestigious hospitals in the U.S. tend to be nonprofits
14. Chris’s car won’t start. He has no training as a mechanic.
    1. How effective is he personally in analyzing the need for the repair recommended by a mechanic?
    2. In the U.S., are auto repair shops usually nonprofits or for-profit firms?
15. Second Type of Information Problem: Personal Contact
16. Elizabeth, who lives in NY, wants to buy flowers for her mother, Francis, who lives in Chicago and is celebrating a special birthday. Is Elizabeth likely to buy flowers from a nonprofit or a for-profit firm? Why?
17. Gail, who lives in NY, wants to contribute to provide emergency relief for an earthquake in Asia.
    1. Is she likely to contribute to a nonprofit or a for-profit firm? Why?
    2. How (if at all) is the information problem Gail faces different from the one Ben, Chris, and Debbie faced in question # 4?
    3. Could advances in technology change her assessment of this issue?
18. Third Type of Information Problem: Impact
19. Ilene loves to run, stroll, and ride her bike in Riverside Park. She appreciates that everyone who wants to enjoy the park is allowed to do so free of charge. She knows that the park needs to be maintained, and that New York City only covers a portion of this cost, so she decides to make a donation.
20. Given how much time she spends in the park, does Ilene still face the same sort of challenge as Gail in question # 5?
21. In deciding whether to donate, does she face a different information problem? Can the use of a nonprofit help to address this problem?
22. Review: This course has emphasized two different types of problems that can undermine an otherwise beneficial transaction. One is about information. What is the other type of problem? (Hint: It also starts with an “i.”)
23. Externalities, Incentives, and Public Goods
24. Helen and Ilene live on a private road, which is not maintained by their town. In the summer, there are a lot of mosquitos. A portion of the land along the road is owned by the town, but the town does not spray it with pesticides to reduce the mosquito population. Instead, the town has given permission to Helen and Ilene to spray it. If Helen sprays the parcel owned by the town, will Ilene also benefit?
25. If Ilene sprays the parcel, will Helen also benefit?
26. What effect do your answers to part “a” and “b” have on Helen and Ilene’s incentive to spray?
27. What does the term “free riding” mean?
28. Economists define a “public good” as a commodity or service that costs the same–regardless of how many people use it–and is available even to those who don’t pay for it. Is a mosquito-free neighborhood a public good?
29. Nonprofits as a Response to Public Goods and Other Incentive Problems
30. Mary is worried about climate change. She founds a research organization to study what causes climate change, how to slow or reverse it, and how to mitigate its effects
31. Is there a subsidy for nonprofits?
32. What comparative advantages do nonprofits have over the government?
33. What comparative advantages do governments have over nonprofits?
34. Special Problems at Nonprofits. To see them, let’s compare two scenarios:
35. Alice is a board member at Forprofit Corp (“FC”), and Ben is FC’s CEO. FC has two businesses: a restaurant and a catering business. At a board meeting, Ben tells Alice and the rest of the board that he wants to stop the restaurant, and keep only the catering business.
    1. To vet this decision, what is the first question Alice should ask?
    2. Assume that running a restaurant requires more work from management than catering. Why might Ben try to hide this fact from Alice?
    3. If this is the reason why Ben wants to shut the restaurant, how feasible is it for Alice to figure this out?
36. Alice is also a board member at Nonprofit (“NP”), and Candace is NP’s CEO. NP has two programs: they run a soup kitchen and they run an afterschool basketball program for disadvantaged young people. Candace tells Alice and the rest of the board that she wants to end the soup kitchen and focus only on basketball.
    1. Compared with Ben’s proposal in the previous question, is Candace’s plan easier or harder for Alice to vet?
    2. Assume that the soup kitchen requires more work from management. Why might Candace try to hide this fact from Alice?
    3. If this is the reason why Candace wants to shut the soup kitchen, how feasible is it for Alice to figure this out?
37. The last two questions illustrate the fundamental challenge at nonprofits that is emphasized in *How to Save the World*.
    1. What is the problem?
    2. Is this a problem of information? Or of incentives? Or both?
    3. What parallel do you see to venture capital?
    4. Can the nonprofit form be explained as a solution to information and incentive problems?
    5. Does the nonprofit form creates a range of information and incentive problems of its own?
38. Inertia
39. Doug and Ellen work at Institution, which provides goods and services to the public. To do this work, Institution has standard operating procedures, which it has used for many years. What it be practical for Doug and Ellen to rethink those standard operating procedures every morning when they arrive at work?
40. Does every organization needs standard operating procedures to do its work?
41. Institution’s standard operating procedures used to be really effective. But the market they serve has changed, so Institution should change some of these procedures to keep up with the times. Are there reasons why Doug and Ellen might resist changing these procedures?
42. Do you think inertia is a challenge at every institution? Why might it be a greater challenge at a nonprofit than at a for-profit firm?
43. Is inertia caused by information problems? Or incentive problems? Or both?
44. Challenges in Resolving Conflicts
45. Frank and Georgia work at Investment Bank, while Hannah and Ike work at Nonprofit. Assume that all four of them are ambitious and capable, and that they enjoy their work. Assume also that Frank and Georgia disagree about the best strategy for Investment Bank to maximize profits, and that Hannah and Ike disagree about the best way to advance Nonprofit’s mission. Why might the disagreement at Nonprofit be more heated? What connection, if any, is there to the fundamental challenge at nonprofits discussed in question #11.
46. Similarly, why might it be harder to reach a compromise at Nonprofit?
47. Effectiveness of the Nondistribution Constraint
48. Lucy, who lives in NY, wants to give money to help poor children in her hometown of Chicago. She finds out about a nonprofit called “Chicago Kids” or “CK,” studies their website, and confirms that their mission is to help low-income children in Chicago. She also confirms that “CK” is a nonprofit, and that the CEO’s name is Marvin, and the Board Chair’s name is Natalie. If CK runs a surplus, can Marvin and Natalie take it as a dividend?
49. Which of the following is true?
    1. CK’s rent per square foot must be below the median rent in Chicago’s real estate market.
    2. Natalie cannot be Marvin’s childhood friend or his relative, since this sort of personal tie between a board chair and CEO would represent an impermissible conflict.
    3. Marvin cannot take 8 weeks of vacation every year.
    4. Marvin cannot receive an 8% raise three years in a row.
    5. Marvin cannot receive a bonus equal to 5% of the surplus that CK runs each year.
50. How reliable is the nondistribution constraint in keeping nonprofit managers and boards from skimping on quality or overcharging beneficiaries?
51. Incentive Compensation
52. What role does incentive compensation play in venture capital? Why?
53. As a legal matter, can similar compensation be used at nonprofits?
54. Agency Costs
55. Richard is the new CEO of a chain of for-profit restaurants in major cities across the U.S., and you are a member of his company’s board. Richard’s predecessor, Sally, was on the road half the time, visiting the restaurants and meeting with their managers. Sally’s motto as a manager was, “there’s no substitute for being there.” She believed that her periodic visits motivated the manager of each restaurant to work harder, and that her visits allowed her to share good ideas from one restaurant with others. Sally also loved traveling, and was proud of having elite “platinum” status at a number of airlines and hotels. On each trip, when the work day ended, she made plans with one of her many friends in each of the relevant cities. Richard is going to try a different approach. He is scheduling an individual video conference with each restaurant manager every two weeks, and a group video chat for everyone every two weeks as well. He plans to travel once a month to visit a restaurant “live,” and will visit each of the 36 locations every three years (instead of every year, as Sally did). As a board member, you are trying to evaluate whether Richard is right to make this change. What information can help you to make that judgment over time?
56. The same facts as in “a,” except that the relevant institution is a network of welfare centers and soup kitchens. Is your job in evaluating the CEO’s choices easier or harder?
57. How to Save the World suggests ways to deal with incentive and information problems at nonprofits. Specifically, the book says that the best nonprofits are effective at two tasks.
58. What are these tasks?
59. The book also suggests synergies in these tasks–that is, working on each one can help a nonprofit make progress on the other. What are those synergies?