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Nonprofits in Health Care: Are They More Efficient and Effective?

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INTRODUCTION

Too often "profit" is equated with "greed." The word implies to many an unrelenting seeking of gain, even at the expense and suffering of others. This reasoning implies that one man's profit is derived from another man's loss.

With the possible exception of education, perhaps nowhere is the notion of profit more widely condemned than in health care. The argument against profit in health care is that a profit-making hospital or other entity is in business to make money rather than to cure people. Consequently, the pursuit of profit would seem to encourage health providers to avoid treating those with low incomes and those who are sickest.[1] Some of President Obama's remarks in town halls on health care appear to question if doctors interested in profit have their patients' best interests in mind at all.[2]

These views lead some to conclude that enterprises providing health services should be organized as nonprofits. A proposal being floated in the corridors of the Arizona capitol would require that Regional Behavioral Health Authorities (companies contracted with the state as health maintenance organizations specializing in behavioral health) be nonprofits.[3] After all, it can be reasoned, the law requires that nonprofits provide some type of "community benefit."[4] Without the bottom line of profit, nonprofits can pursue other goals such as "concern for justice, the dignity of persons and a community-centered ethics that places the needs of people before profits."[5]

However, sophisticated econometric studies indicate that nonprofit nursing facilities are less efficient than for-profit ones.[6] Based on the limited research contrasting for profit and nonprofit performance, there is no reason to presume greater net benefits from nonprofits than from for profits.[7] In fact, it is not only possible but likely that for profit enterprises are more accountable than are nonprofits that compete with the for profit world.

Government policy should, therefore, remain neutral toward nonprofits and for profits competing in the market place for government contracts. There should be no restrictions against for profit companies competing for government contracts. Issues of accountability should be completely contained in contracts, not left to vague idealistic images of what nonprofits ought to be.

Profit's Role

Profit is perhaps one of the most misunderstood economic concepts.[8] For this reason, it is not possible to compare and contrast for profit and nonprofit enterprises without first clearing up the concept of profit (and losses) and the role it plays in allocating resources. Once this is better understood, it is possible to contrast incentives in the nonprofit world more accurately with those at play in the for profit world.

Economists recognize profit as a residual. Profit is what is left over when costs are deducted from revenue. It is not, as many think, "the simple ancient habit of adding as much of one's profit to a product or service as possible."[9] Neither is it true that profit is "passed on to consumers as part of the price of their policy premiums"[10] in the case of health insurance. Profit cannot be "passed on." Costs can be passed on, to some extent, when costs like taxes or prices of basic inputs like energy go up for all producers, but in a competitive market profit cannot be passed on because profit is not pre-determined. Profit is simply what is left over after costs are covered. Entrepreneurs, of course, do their best to make sure as much as possible is left over.[11]

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Most business people want at least an acceptable level of profit and that level will vary under different circumstances, markets, and business models. However, because market forces are largely impersonal, much is outside the business person's control. Competition keeps final product and service prices in check. Similarly, market determined labor and input prices keep costs from being entirely under a business's control. Profit, therefore, becomes a target or a test for the financial viability and economic worth of something offered in the market.

Since profit is the mathematical difference between revenues and costs, there are only two ways to make profit as large as possible. Either produce something consumers are willing to pay a lot for (e.g., raise revenue) or be as efficient as possible (e.g., lower cost). Generally, producers do both in their competitive pursuit of profit.

If hoped for profits fail to materialize, companies refocus and make something else or find out how to wring out new efficiencies (stretching and saving valuable resources) or go out of business altogether. Entrepreneurs go back to working nine-to-five jobs and inventors go back to the drawing board. When hoped for profits do materialize, or if a product is truly a wild success, companies double down. Entrepreneurs look for a niche in the new market; inventors look for ways to improve the product without violating existing patents.

Ultimately, a profit driven world is a consumer driven world. Consumers decide the worth of a final product and, therefore, its profitability. The only reason it might look as if profit is predetermined is because producers react so quickly, pulling low-valued, unprofitable products off the market. Such is the power of profit (and losses). Its pursuit has done much to help us have a higher standard of living by making sure valuable resources are used to produce only those things we most highly value.

The Logic of Nonprofits

Nonprofit organizations exist for one major reason: corporate income is taxed. The income tax is primarily intended to tax income that derives from current production. Thus, wages and salaries are taxed; proprietors' profits are taxed; corporate income is taxed (and double taxed when paid in dividends); interest earnings, presumably resulting from productive activity made possible by loans, are taxed; and, pure wealth transfers are taxed in the form of inheritance taxes, but the exemption is fairly large at $1 million.

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Wealth transfers for charitable purposes are specifically not income taxed by way of income deductions for charitable giving. Such giving, however, must be to a bona fide charity or nonprofit organization. Besides avoiding discouraging America's long-charitable traditions, the deduction can be justified because the transfer is not an act of consideration in an exchange. It is a pure wealth transfer and income taxing the transfer would be double taxation just as the current inheritance tax is double taxation.

For an organization to qualify as a nonprofit, it must appropriately incorporate in a state. Following incorporation, the organization may engage in any line of business, charging customers whatever it wants. To receive a federal tax exemption, however, a nonprofit entity has to promote one of the specific purposes set forth in Section 501(c)(3) of the Internal Revenue Code. None of the organization's earnings can be paid out to shareholders or any other individual; they must be retained to promote the organization's stated purpose.[12]

Nonprofit organizations are expected to confer some type of benefit on the community. In the Goldwater Institute's case that purpose is educational. Nonprofit hospitals were once largely charity hospitals and were not charging for their services; indeed, they were restrained from such profit by federal law. After 1969, the Internal Revenue Service (IRS) changed its rules into a rather vague community service standard for nonprofit qualification. Now hospitals may continue to qualify as nonprofits by providing community benefits in other ways such as "offering health fairs, screening for cancer and cholesterol, providing emergency care, training doctors and conducting medical research."[13]

Nonprofits vs. For Profits in Health Care

In recent years, nonprofits' privileged tax status in health care has come under fire partly as a result of the 1969 IRS policy change. There is a broad argument that nonprofits in general are inefficient. There also are specific criticisms of nonprofit hospitals. One leading concern is that although there is a specific prohibition against nonprofits distributing earnings, those earnings can be effectively laundered and paid out as salary, perks, and benefits. The degree to which this might be a problem is difficult to gauge.

Incentives inherent in nonprofits are not the same as those of for profits. Nonprofits, whose revenues are largely from charitable donations, generally create a product that is not sold in a market, so there is not a direct evaluation of production value by consumers. Also, without a profit motive, the incentive to drive down costs may be relatively weak whereas buyers of a for profit's product merely have to directly evaluate the worth of that product and donors who are the buyers of a nonprofit's product must monitor the nonprofit in different ways that can be more costly and difficult.[14]

Government policy should, therefore, remain neutral toward nonprofits and for profits competing in the market place for government contracts. There should be no restrictions against for profit companies competing for government contracts.

One area that has seen focused scrutiny with regard to nonprofit costs is executive pay, especially among charitable service nonprofits like the United Way and Goodwill.[15] Executive compensation for nonprofit health care organizations also has come under scrutiny.[16] The U.S. Government Accountability Office (GAO) conducted a survey on executive compensation at nonprofit hospital systems at the behest of Congress. One area of particular concern was generous retirement benefits for top nonprofit officers.[17]

As Economist Thomas Sowell of the Hoover Institution notes in a critique of nonprofits the extent to which the idealism of those who run nonprofits "offsets the common human temptation to self-indulgence is an empirical question."[18] Indeed, efforts have been made to empirically gauge whether nonprofit health providers are more or less efficient than for profit health providers. The empirical results are decidedly mixed.[19] Some studies show for profits with the efficiency advantage, others show nonprofits with the advantage, while still others show no advantage for either organizational structure. Empirical studies intended to find out whether nonprofits are more or less efficient than for profits largely focus on a comparison of for profit and nonprofit hospitals.

It may be expected that the two types of organizations' practices would converge. Nonprofits operate in the same world as for profits. To some extent, it may be assumed that personnel would cycle between nonprofit and for profit enterprises. Both compete for contracts. If one is more efficient than the other, the less efficient will have an incentive to find out why and adopt the more efficient practices.

Sophisticated econometric studies have indicated that nonprofit nursing facilities are less efficient than for profit ones.[20] An acknowledged shortcoming of these studies is the lack of qualitative measures. Quality is inherently difficult and probably impossible to fully measure. On the other hand, this is an advantage of for profit provision of services. The consumers get to decide what qualitative attributes they value and can seek them out. Given that quality is inherently subjective, it seems most appropriate that consumers, rather than providers, decide what is qualitatively important.

One study of for profit versus nonprofit hospitals shows that for profits are more likely to offer services that are more profitable. The implication seems to be that the pursuit of profit leaves service gaps that nonprofits fill. The study itself shows that some for profits offer services in each of the service categories examined; they are just not as prominent in areas where there is lower profitability.[21]

Even where qualitative differences in performance between for profits and nonprofits might exist, it is questionable whether it is wise policy to continue to extend what is effectively a tax subsidy to nonprofit health care institutions. This is especially the case when nonprofit hospitals are some of the most aggressive in seeking payment of "exorbitant" medical bills.

Interestingly, the empirical result that for profits avoid less profitable services actually confirms the economist's critique. Pursuit of profit drives producers and resources into highly valued goods and services and drives down costs. Nonprofits' higher probability of offering services of low profitability implies two things. First, nonprofits persist in offering services of lower value compared with other services implying inefficiency since resources should move to increase the supply of services consumers (patients in the case of health care) value the most. Second, by persisting in their niches, nonprofits tend to create a higher supply in their service areas, which automatically makes those areas less profitable. This means that the study's conclusion is self-fulfilling and largely not meaningful without first showing that less profitable services are of a higher non-pecuniary value than profitability would indicate.

Another study by Paul Gertler, University of California, Berkeley - Haas School of Business, National Bureau of Economic Research, and Jennifer Kuan, Stanford University, Institute for Economic Policy Research, sought to compare sales of for profit and nonprofit hospitals to determine relative efficiency. The reasoning is that if for profits are more efficient than nonprofits, nonprofit hospitals should sell for less than for profits. The findings were that for profit hospital chains paid as much for hospitals regardless of whether they were for profit or nonprofit. The conclusion drawn was that there were no efficiency differences between the two. This result was attributed to a generous like-mindedness and cooperation among nonprofits.[22]

The sales study also has shortcomings. For profits could be expected to see value potential that nonprofits would not since for profits have a greater incentive to look for highly profitable opportunities. They also compete with each other for facilities, regardless of who is selling, and it would be difficult to evaluate the degree of competition for the facilities placed for sale in such a study. If nonprofits are more likely to be inefficient and invest accordingly, it would be expected that some nonprofits' assets would not be highly valued by those whose missions are to find assets with real value. It could be that nonprofits sell at lower prices to like-minded nonprofits because many nonprofit facilities have a relatively low market value in the first place.

It is not at all clear why a business that retains its earnings should be exempt from taxation while another business that pays out earnings, or otherwise creates value to owners, is taxed.

Given the conflicting nature of the evidence, and the ease with which studies that purport to show nonprofit efficiency can be refuted, it follows that unquestioning faith in nonprofit health care organizations should face some scrutiny. Even where qualitative differences in performance between for profits and nonprofits might exist, it is questionable whether it is wise policy to continue to extend what is effectively a tax subsidy to nonprofit health care institutions. This is especially the case when nonprofit hospitals are some of the most aggressive in seeking payment of "exorbitant" medical bills.[23]

Implications for State Policy

States have a good deal of latitude in determining legitimate nonprofit behavior. A nonprofit that is almost entirely dependent on contributions and does not engage in political behavior is clearly operating within the traditional confines of nonprofits. The line becomes blurred when nonprofits provide services and charge fees or enter into contracts for consideration in direct competition with for profits. It is not at all clear why a business that retains its earnings should be exempt from taxation while another business that pays out earnings, or otherwise creates value to owners, is taxed.[24]

Resist Calls to Favor Nonprofits in State Contracting

There are always efforts to favor nonprofits in state contracting. Arizona's Legislature resisted the temptation to limit charter schools to nonprofit entities and has managed to avoid some of the negative effects of such a policy. Because nonprofits are organized around boards but can contract with for profits, it can be difficult at times to hold nonprofit actors accountable. Often nonprofit entities are essentially artificial constructs to get around such laws.[25]

At one time, only nonprofits were allowed to bid for the position of Regional Behavioral Health Authorities (RBHAs) in Arizona. RBHAs act as behavioral-health HMOs (health maintenance organizations), or middlemen bringing service providers and consumers together. In 1996, the state's auditor general recommended for profits be allowed to operate as RBHAs, mainly because there was at one point only one bidder for the position in Maricopa County. Since then, for profit contractors present no more problems and issues with meeting contract obligations than nonprofits.[26]

Based on the limited research contrasting for profit and nonprofit performance, there is no reason to presume greater net benefits from nonprofits than from for profits. One complaint is that for profit companies often come from out of state—that is, by limiting contracts to nonprofits, it is more likely tax money paid for administering state programs and for serving Arizonans will stay in Arizona.[27] It does not matter then where a service provider is or what the money flows are from an economic perspective. The issue is whether or not the highest possible net value is being achieved. If a for profit can underbid a nonprofit and meet the same contractual obligations, it makes no difference where the for profit is located as long as patients receive better service at a lower cost.

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Tighten State Law to Create a Brighter Line Between for profit and Nonprofit Entities

The original IRS rules concerning nonprofits were based on what may be called a redistributionist philosophy. Nonprofits are supposed to produce services, but their non-tax status resulted from their being funded largely through contributions, e.g., wealth transfers. Nonprofits' tax privileged status also resulted from their missions of providing something of value to the community as a whole.

The line between nonprofit and for profit becomes very blurred once nonprofits start charging directly for goods and services. Such charges imply that the nonprofit is producing benefits for its patrons instead of community benefits for the population it is supposed to serve. A nonprofit charity hospital that serves only the indigent and low income populations would arguably be providing community benefits as a private form of social insurance. Such a nonprofit, heavily dependent on donations, is justifiably not taxed because of the wealth transfers. In the case of nonprofit hospitals and health providers that are principally funded through the fees charged for the care they provide, the legislature could consider clarifying what qualifies as charitable care and require that a minimum amount of the provided care be given for free to patients unable to pay for services and require that care to be funded through charitable contributions.

Conclusion

There is a widespread view that it is wrong to profit from health care. After all, except for an occasional checkup or physical, most visit a doctor only when they are ill. It seems morally wrong to profit from the sufferings of others. Upon further examination, however, this view is fundamentally flawed. Profiting from health care is profiting from increasing the quality and length of peoples' lives, not from their suffering.

Economic principles and econometric studies indicate that for profit health care providers are just as effective, if not more effective, at providing health care services as are nonprofit providers. Legislators should, at a minimum, treat nonprofit and for profit providers equally in government contracting.

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NOTES

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2. American Academy of Otolaryngology—Head and Neck Surgery, "Nation's ENT Surgeons Respond to President Obama's Press Briefing Remarks on Tonsillectomy Procedures," press release, July 23, 2009, http://www.businesswire.com/portal/site/home/permalink/?ndmViewId=news_view&newsId=20090723006009&newsLang=en.

3. This proposal has been proffered by Ted Williams, a member of Arizona governor Jan Brewer's transition team.

4. David A. Hyman and William M. Sage, "Subsidizing Health Care Providers through the Tax Code: Status or Conduct?" Health Affairs 25, no. 4 (2006): w312–w315, http://content.healthaffairs.org/cgi/content/full/25/4/W312.

5. Claire Andre and Manuel Velasquez, "A Healthy Bottom Line: Profits or People?" Issues in Ethics [Santa Clara University] 1, no. 4 (Summer 1988), http://www.scu.edu/ethics/publications/iie/v1n4/healthy.html.

6. Kris J. Knox, Eric C. Blankmeyer, and J. R. Stutzman, "The Efficiency of Nursing Home Chains and the Implications of Nonprofit Status: A Comment," Journal of Real Estate Portfolio Management 7, no. 2 (2001), http://sbaeweb.fullerton.edu/finance/jrepm/pdf/vol07n02/09.177_182.pdf.

7. Ted Williams, telephone interview with author, August 25, 2009.

8. Thomas Sowell, Basic Economics (New York: Basic Books, 2000), 74.

9. Huer, 6.

10. David R. Remer, "Health Care, Profit vs. Non-Profit," Political Meanings, June 23, 2009, http://poliwatch.org/remers/2009/06/23/health_care_profit_vs_non-prof.php.

11. Sometimes, entrepreneurs try to cheat and not cover their costs, keeping what should be paid to creditors and suppliers for themselves and absconding. There are penalties, including jail, for such cheating.

12. For additional information, see the IRS exemption requirements at http://www.irs.gov/charities/charitable/article/0,,id=96099,00.html.

13. Robert Pear, "Nonprofit Hospitals Face Scrutiny Over Practices," New York Times, March 19, 2006, http://www.nytimes.com/2006/03/19/politics/19health.html.

14. Sowell, 333–337.

15. Niki Jagpal, "Nonprofit Executive Compensation—Who Decides What Is Fair and How?" entry on National Committee for Responsive Philanthropy weblog, July 3, 2008, http://www.ncrp.org/blog/2008/07/nonprofit-executive-compensation-who.html; Emily Steel, "He's the Highest-Paid Charity Executive Around," St. Petersburg (Fla.) Times, August 15, 2005, http://www.sptimes.com/2005/08/15/Business/He_s_the_highest_paid.shtml.

16. Anne Zieger, "MA AG Cracks Down on Non-profit Health Exec Compensation," FierceHealthcare, September 4, 2009, http://www.fiercehealthcare.com/story/ma-atty-general-cracks-down-non-profit-health-exec-compensation/2009-09-04.

17. Sonnenschein Nath & Rosenthal LLP, "GAO Issues Report on Compensation Policies and Practices at Nonprofit Hospital Systems," Health Care Law e-alert, Chicago, July 31, 2006, http://www.sonnenschein.com/docs/docs_e-alert/gaoreport.pdf; Linda M. Calbom, "Nonprofit Hospital Systems: Survey on Executive Compensation Policies and Practices," briefing to the Chairman, Committee on Ways and Means House of Representatives, Washington, D.C., U.S. Government Accountability Office, GAO-06-907R, June 30, 2006, http://www.gao.gov/new.items/d06907r.pdf.

18. Sowell, 336.

19. Mark Schlesinger and Bradford H. Gray, "How Nonprofits Matter in American

Medicine, and What to Do About It," Health Affairs 25, no. 4, (2006): 297–303. http://content.healthaffairs.org/cgi/content/full/25/4/W287.

20. Kris J. Knox, Eric C. Blankmeyer, and J. R. Stutzman, "The Efficiency of Nursing Home Chains and the Implications of Nonprofit Status: A Comment," Journal of Real Estate Portfolio Management 7, no. 2 (2001), http://sbaeweb.fullerton.edu/finance/jrepm/pdf/vol07n02/09.177_182.pdf.

21. Jill R. Horwitz, "Making Profits and Providing Care: Comparing Nonprofit, For-profit, and Government Hospitals," Health Affairs 24, no. 3 (2005): 790–801, http://content.healthaffairs.org/cgi/content/full/24/3/790.

22. Paul Gertler and Jennifer Kuan, "Using Hospital Sales Prices to Test Nonprofit Efficiency," working paper, May 5, 2002, http://faculty.haas.berkeley.edu/gertler/working_papers/gertler_kuan_5-05-02.pdf.

23. Hyman and Sage, w312–w315. See also Malik M. Hasan, "Let's End the Nonprofit Charade," New England Journal of Medicine 334, no. 16 (1996): 1055–57, http://www.faqs.org/abstracts/Health/Lets-end-the-nonprofit-charade-History-of-visible-rectal-bleeding-in-a-primary-care-population-initi.html.

24. This occurs in the for-profit corporate world. All corporations pay income tax on profits. Corporations that distribute earnings as dividends are double-taxed, because the dividends are taxed as shareholder income on top of being taxed as corporate profits. Corporations that retain their earnings only pay the corporate income tax. Some believe that corporate accountability has suffered as a result of tax policy discouraging business discipline that seems inherent in distributing dividends.

25. In Texas, for-profit educational companies would often write the educational and business plans of nonprofit entities and even take part in recruiting board members. In such cases, boards were more symbolic than managerial. Instead of straightforwardly changing the law to allow for-profits to operate charter schools, the Texas legislature opted for direct regulation that has stifled innovation.

26. Mike Fronske, telephone interview with author, August 11, 2009.

27. Ted Williams, telephone interview with author, August 25, 2009.