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Impure prosocial motivation in charity provision: Warm-glow charities and implications for public funding ☆

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ABSTRACT

We show that warm-glow motives in provision by competing suppliers can lead to inefficient charity selection. In these situations, discretionary donor choices can promote efficient charity selection even when provision outcomes are non-verifiable. Government funding arrangements, on the other hand, face verification constraints that make them less flexible relative to private donations. Switching from direct grants to government subsidies for private donations can thus produce a positive pro-competitive effect on charity selection, raising the value of charity provision per dollar of funding.

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1. Introduction

What is a warm-glow charity? To the extent that charities (or the non-profit entrepreneurs who run them) are prosocially motivated, they care about what they provide. However, they also typically favor their own output relative to that of other providers—which is why, for example, they compete with charities similar to themselves for available funds. The reason why they favor their own output may be that the goods and services provided are different; but there is also ample anecdotal evidence that the preference stems from impure altruism, i.e. that non-profit entrepreneurs derive a direct benefit from being involved in non-profit provision even when what they provide is a homogeneous good.[1] So, a warm-glow charity is one that places a premium on own provision irrespectively of whether it is differentiated from that of other charities.

In this paper we show that, unlike donors' warm glow, which can promote private giving and offset incentives towards inefficiently low levels of collective good provision (Andreoni, 1988, 1990), warm-glow motives for providers can have adverse effects on allocative efficiency. If non-profit entrepreneurs are prosocially motivated, but impurely so (i.e. if they experience warm glow from their own provision), then they will face incentives to enter the non-profit sector and compete with other charities in situations where the technology they have access to is dominated by that of other charities. This gives rise to inefficient charity selection, with the result that total output is not maximized for the given resources that donors and government allocate to the non-profit sector.

In the for-profit sector, market competition in the provision of private goods and services is the standard mechanism through which positive selection of firms is promoted. This can be effective even in situations where information about technology is private to providers (which is typically the case), and even though the profit maximizing objectives of firms are in structural opposition to the utility maximizing objectives of consumers and objectives of other firms. Competition in the non-profit sector is different, for the simple reason that pricing mechanisms can no longer be used as effective selection devices. Private information about technology combined with impure prosocial motivation on the part of providers can give rise to selection failure.

Nevertheless, discretionary donor choices in a repeated funding relationship can promote efficient charity selection. As we show,

[1] This is often reflected in charities' mission statements. To give an example, one of the key objectives in St. John Cymru Wales (a first aid charity operating in Wales) is to "establish St John Wales as the first choice for first aid throughout Wales".

sequential donations conditioned on past performance can offset the selection bias arising from impure prosocial motivation on the part of providers, and improve ex-ante charity selection — and the more so the more charities are prosocially motivated. However, this requires the conditioning to be free from verification constraints. Since private donations are fully discretionary, private donors do not face any verification constraints and are therefore able to leverage on such incentives to the fullest.

Government, on the other hand, faces verification constraints that may reduce its ability to screen efficient charities in comparison with private donors: accountability requirements with respect to the use of public funds imply that the government must design an explicit mechanism based on *verifiable* signals (which may be imperfectly correlated to observed performance), whereas private donors do not face such constraints and can therefore condition donations directly on observed performance. These verification constraints can dominate any informational advantages the government may have relative to private donors in terms of its ability to observe charity performance, with the result that private donations will be superior to government funding as a way to promote efficiency in provision.

This result relates to the ongoing debate about why tax incentives for giving are used as a significant channel for delivering public support to charities instead of relying solely on direct government grants — a question that has provoked much debate, and still does, especially in light of the steadily increasing size and importance of the charitable sector and the corresponding increase in the level of government support directed to non-profit enterprises. In our analysis, we show how the presence of impure prosocial motivation on the part of providers can provide a supply-side based rationale for the use of tax incentives for private giving: relying on tax incentives as alternatives to direct government grants may improve charity selection and performance — an effect that would remain unmeasured in empirical estimates that focus on effects on the *cost* of provision by charities as measured by their overall budgets (their inputs) rather than the provision itself (their output). This also implies that measuring the crowding effects of government grants in terms of their effects on the volume of funding may understate their true impact on the effective (productivity-adjusted) level of provision.

Whereas the donor's problem has received considerable attention in the literature, less is known about the way in which charities' affect public good provision. The theoretical literature on conduct and performance in the not-for-profit sector has mainly focused on the relative advantages of for-profit and non-for-profit organizational forms in terms of information and agency costs, differential regulatory and tax regimes, and implications of reliance on a prosocially motivated workforce (see Hansmann, 2012, for a recent survey). The line of questioning in this paper is related to that literature, but its specific focus is on the implications of impure prosocial motivation in provision on charity selection and output — an aspect that has so far not been examined by the literature. It is also closely related to the literature on the relationship between donor choices in the presence of information constraints (Vesterlund, 2003; Potters et al., 2005, 2007), and to the literature debating the effects of alternative modes of government funding on levels of donations (e.g. Andreoni and Payne, 2001; Feldstein and Clotfelter, 1976).

The rest of the paper is organized as follows. Section 2 formalizes the idea of positive charity selection from performance-based contributions. Section 3 focuses on the comparison between private contributions and government grants. Section 4 concludes.

2. Private philanthropy and competitive charity selection

In this section we develop a simple framework for modeling competition between non-commercial, not-for profit providers of a homogeneous collective good. The setting abstracts from a number of important aspects of real-world competition between charities (e.g., product differentiation,

commercial activities, scale economies in provision, contracting problems within charities) in order to highlight the distinctive features of the mechanism through which non-commercial, not-for-profit firms compete and are selected. The key features of this selection mechanism are: (i) charities can choose whether or not to participate in provision; (ii) charities are prosocially motivated but value their own provision more than that of other charities; (iii) charities differ in terms of their productive efficiency and funders are ex ante unable to observe a charity's productivity type; (iv) ex post, upon observing how the charity has performed, funders can choose to divert their funds towards another charity. In this framework, the selection of charity productivity types – and the resulting level of productivity of funds directed to them – is an equilibrium outcome, which can be affected by the mode of funding.

This section focuses on private contributions only. In the next section, we also discuss government grants and contrast them with private contributions in terms of their informational requirements and their implications for charity selection.

2.1. Warm-glow charities and private donors

Consider an economy where there are charities and private contributors. Suppose that there is a continuum of different charity types, with a constant mass of charities for each type. Charities use resources from private contributions to provide a collective good, and differ from each other only with respect to the probability that the provision they carry out will succeed in its aims. A charity of type π ($0 \leq \pi \leq 1$) that uses a given amount of resources to provide a collective good will be successful in provision with probability π and unsuccessful (i.e. no provision follows from the resources used) with probability $1-\pi$. Assuming, without loss of generality, that the unit cost of provision is equal to unity, then expected provision per unit of expenditure for the charity is thus π. Charities of different types are uniformly distributed in $(0, \overline{\pi}]$, $\overline{\pi} \leq 1$.[2] Throughout the rest of this section, we assume that output is perfectly observable; this will be relaxed in the following section. Without loss of generality, and to simplify the presentation, we assume $\overline{\pi} = 1$.

Private contributors value expected provision – and thus favor more successful charities over less successful ones – but otherwise view provision by one charity as a perfect substitute for provision by another charity (the extreme case of perfect substitution is a convenient benchmark). The overall level of expected provision from the point of view of an individual, i, contributing an amount c_i is thus

$$e_i c_i + G_{-i}, \tag{1}$$

where G_{-i} is expected provision through contributions by individuals other than i, and e_i is the expected provision per unit value of i's contribution.

Charities, on the other hand, derive warm glow from their own provision relative to that of other charities, in the sense that they value the overall provision of the public good or service but also derive an additional benefit from their own contribution to the provision. As Andreoni (1989) puts it, this additional benefit stems from a feeling of having "done one's bit" — an effect that his original contribution invokes with reference to donors' motives but which can equally apply to the motives of charities' managers. It may well be that the premium that charities attach to own provision is due to the presence of 'ego rents' for managers or trustees or from pecuniary motives of managers that relate to the size of the organization (for example, managers can draw a

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[2] The probability of success, π, plays an analogous role here as provision quality does in other frameworks (e.g., Glaeser and Schleifer, 2001). The main advantage of modeling performance in this way is that – as shown later – this specification yields a simple and convenient representation of informational asymmetries. The zero-one (failure-success) formulation is without loss of generality — our analysis and results would carry through to a formulation where a low output/low quality outcome does not entail complete failure (zero output).