



**The Basics:
An Overview of the Essential Features, Size, and Scope of the U.S. Nonprofit Sector**

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I was very pleased to be asked to lead several “class” sessions about the U.S. nonprofit sector for Independent Sector staff. The first session covered foundational information about the essential features of nonprofit organizations and the overall size and structure of the nonprofit sector. Session two will focus on the history of the nonprofit sector, and session three will consider current challenges facing the nonprofit sector and the sector’s possible future directions. The three class sessions will be recapped in three short summaries. This is the summary of the first class session.

In the first session, we began by noting that the nonprofit sector is one of three major sectors of our society, with business and government. Organizations can qualify as nonprofit – or tax-exempt – under approximately 20 sections of the U.S. tax code. However, the focus of Independent Sector’s work is largely on the charitable portion of the nonprofit sector which includes organizations exempt specifically under section 501(c)(3) of the tax code. To qualify for tax exemption under section 501(c)(3), organizations must pass a five-part test that requires that they have some structure; be engaged in certain prescribed charitable activities; not distribute their profits; not be substantially involved in lobbying; and not be involved in political campaigns on behalf of any candidates. Only charitable nonprofits – those exempt under section 501(c)(3) – have the benefit of receiving contributions that are tax deductible for the donor.

In dollar terms, health and education nonprofits – including large hospitals and universities – dominate the nonprofit sector and account for more than three-quarters of all nonprofit spending. In light of the major revenue sources of these large institutions, it is perhaps not surprising that fees, service charges, and other earned revenue – including patient fees at hospitals and tuition at universities – make up almost half of overall nonprofit revenue according to the National Center for Charitable Statistics at the Urban Institute. Government is the second largest revenue source accounting for about one-third of overall nonprofit income, with philanthropy comprising 10-15 percent of aggregate nonprofit sector revenue. According to *Giving USA*, the annual report on charitable giving, within philanthropy major sources of charitable contributions are individuals (70 percent of all contributions), foundations (16 percent), bequests (9 percent), and corporations (5 percent).

In his visit to the U.S. from France in the early 1800s, Alexis de Tocqueville famously observed that Americans are constantly forming associations, or what we might today call “nonprofits.” Lester Salamon has more recently observed that there has been a “global associational revolution” over the past several decades, with nonprofits increasing in number not only in the U.S. but also around the world. Today, the U.S. ranks high – but not at the very top of countries – in terms of the contribution of nonprofits to Gross Domestic Product.

Scholars have asked why we have a nonprofit sector in the U.S. and elsewhere. Their answers take the form of three “failure” theories. According to market-failure theory, associated with Henry Hansmann, nonprofits exist because of the failure of the market to work properly in cases where there are significant information asymmetries – or differences – between sellers and buyers. When sellers know more about the quality of a service or product being sold than buyers, buyers are disadvantaged because they don’t really know what they are getting for their purchase. For example, when adult children buy nursing home care for their elderly parents the buyers don’t always have good knowledge of the quality of care being provided because their elderly parents may not be good reporters of this information. In cases of information asymmetry like this, it is useful to have trustworthy providers of service available that aren’t trying to squeeze every possible dollar of profit out of their service delivery. This is the gap that nonprofits can fill.

In the second, government-failure theory, developed by Burt Weisbrod, nonprofits exist to fill gaps in public services that are not provided by government. According to this theory, government responds to majority interests and provides the level of services that the majority wants. This may leave an unsatisfied minority desiring more services. For example, governments generally provide relatively modest funding for the arts. Those who want more arts-related programming may turn to the nonprofit sector to satisfy their unmet desires.

The third failure theory turns the other two theories on their head and suggests that voluntary sector provision of services comes first and that it is only when the voluntary sector fails to provide the needed services that the market and government step in to provide services. Lester Salamon is the scholar associated with this voluntary-failure theory.