LAW & ECONOMICS WORKSHOP

presents

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Relational Sanctions against Non-Profit Organizations: Why a Selfish Entrepreneur Would Organize a Non-Profit Enterprise

Tuesday, February 10, 2015
4:10 – 5:45
Solarium (room FA2), Falconer Hall
84 Queen's Park

This paper examines how relational sanctions can affect organizational choice. An entrepreneur can set up either a for-profit or a non-profit organization in selling product or service to customers. While the entrepreneur can distribute all the profits from a for-profit organization to herself, she faces a non-distribution constraint with respect to a non-profit organization and has to convert a non-profit firm's profits into private benefits (such as perquisites). Because realized quality is not verifiable and is subject to error, customers, in equilibrium, impose relational sanctions against the firm when low quality product or service is delivered. With the relational sanctions, for-profit and non-profit firms provide the same (expected) level of quality to the consumers in equilibrium. The size of the relational sanctions and the entrepreneur's preference over the organizational form differ, however. When converting profit into private benefits becomes more difficult at the margin, i.e., conversion exhibits decreasing returns to scale, because temptation to shirk from investing in quality gets weaker (but still positive), a non-profit organization is subject to shorter (less severe) relational sanctions. Shorter relational sanctions, in turn, can make a non-profit organization's long-run return to the entrepreneur (in terms of private benefits) higher than that from a for-profit organization (in terms of distributed profits). Hence, even if the entrepreneur has no altruistic motive and cares only about the returns she derives from the organization, she may still choose a non-profit form. The entrepreneur is more likely to organize a non-profit firm (1) as the correlation between investment and quality gets weaker; (2) as the non-distribution constraint gets stronger at the margin; (3) when a for-profit firm is subject to income tax or a non-profit firm is subject to tax subsidy; or (4) and as the profit margin gets smaller due, for instance, to a stronger bargaining leverage of the buyers.

Albert Choi joined the Law School as an associate professor of law and associate director of the John M. Olin Program in Law and Economics in 2005, after teaching as an assistant professor in the University's Department of Economics. His research and teaching interests include law and economics, contract theory, corporate law, corporate finance and organization. He earned his J.D. from Yale Law School in May 2001 and his Ph.D. in economics from the Massachusetts Institute of Technology in September of that same year. While at Yale, he was an Olin Fellow in Law and Economics in 2000-01 and earned John M. Olin Research Fellowships in the summers of 2000 and 2001. At MIT, he was a National Science Foundation's Graduate Research Fellow. Choi was a visiting professor at Yale Law School in 2008-09 and was the Austin Wakeman Scott Visiting Professor at Harvard Law School in 2009-10. From 2011 to 2014, he is serving as a director on the American Law and Economics Association's board. And he is currently an associate editor at the *American Law and Economics Review* and the*International Review of Law and Economics*.

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