

## **The Theory of Non-Profit Organisations: An Application to a Performing Arts Enterprise**

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*Abstract:* A non-profit organisation is one whose profits, or more precisely net earnings, are not legally distributable to controlling individuals. This paper seeks to draw attention to a small part of the economic research now available on this institutional form and to assess its potential application to a specific non-profit performing-arts enterprise in Ireland, namely the Wexford Festival Opera. The evidence is mixed. The greatest difficulty is that there does not appear to be any overall coherent theory of non-profits and many of the theories that do exist extend little beyond fairly simple common-sense reasoning. On the positive side, the theories do provide a useful framework for thinking about non-profits and do throw some light on understanding the existence and structure of the Wexford Festival Opera.

### I INTRODUCTION

**T**he objectives of this paper are twofold: to highlight that part of the growing volume of research into the economics of non-profit organisations that has relevance to the arts and to assess its applicability in relation to one area of significant non-profit, performing-arts activity. For the latter purpose, the degree to which non-profit theory can provide any insights into the existence and structure of an Irish non-profit arts enterprise, the Wexford Festival Opera, is examined. The salient features of this arts company can be summarised as follows: its legal status is that of a charitable

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trust; its repertoire centres almost exclusively on rare operas and innovative productions; it derives its income from a multitude of funding sources, including over two-fifths in the form of box-office/trading income and another substantial component, around one-quarter, from the state; and it benefits significantly from implicit subsidies such as volunteer-labour contributions and below-market price service provision. Nevertheless, despite these features the Festival has, in common with many arts enterprises and non-profits (as they are referred to for short), been characterised by continual financial difficulties for most of its history.

In the preliminary efforts to understand the various facets of this small but complex organisation it became clear that the microeconomic theory of the firm is wholly unsuited for such a task. For one thing, a fundamental assumption of this conventional theory is the existence of property rights over profits, whereas non-profit institutions such as the Festival cannot legally produce distributable profits. Moreover, the theory of the firm assumes an enterprise whose income accrues from market transactions of one form or another, whereas many non-profits derive all or part of their revenue from non-market sources such as government grants and private donations, thus changing the whole nature of the transaction process. It is in recognition of the above that the theory of non-profit organisations has assumed increasing importance.

Section II of this paper considers the precise definition of the non-profit form of organisation. Section III provides a sketch of those elements of non-profit theory that, on the face of it, might have some applications to an organisation operating in the high-culture sector. Section IV is concerned with empirical matters, discussing at some length the cost and revenue structure of an individual non-profit firm, namely the Wexford Festival Opera.

## II NON-PROFIT ORGANISATIONS: DEFINITION AND CLASSIFICATION

Although the non-profit institution existed before the rise of the for-profit business corporation, a generally accepted and workable definition of non-profit enterprise is of quite recent origin. According to Hansmann (1980) an organisation may be considered non-profit if, after wages and other expenses have been deducted from its revenue, it is legally prohibited from distributing any resultant net earnings to controlling persons such as managers, directors, trustees and so forth. Under this non-distribution constraint, as Hansmann terms it, there can be no share capital or any other means of associating control with pure profits distribution, thereby distinguishing non-profits from both proprietary (for-profit) and co-operative forms of enterprise.

Several aspects of this definition bear emphasising. First, it is essentially

legal rather than economic in nature and is very broad in scope. Second, it should be noted that although these organisations cannot produce distributable profits, they are nevertheless usually free to run annual financial surpluses of revenue over costs for the purpose of building a retained-earnings capital base. Last, the non-distribution constraint, to be completely effective in countering profit distribution, must also generally encompass an enterprise's assets as well as net earnings.

The non-profit sector, as defined above, comprises a seemingly disparate mass of organisations operating in areas as varied as nursing care, the arts, lobbying, redistribution, social welfare and environmental protection. A system of classification therefore is needed to categorise in some way these varied institutions. One important distinction is that between private and public non-profit enterprises. Within the private non-profit sector, some further classification is possible in terms of both funding sources and governance structures (Hansmann, 1980). Using the funding criterion, private non-profits can be divided into "commercial" and "donative" categories, where commercial non-profits are those supported chiefly by sales income and donative non-profits are those benefiting from substantial non-market support in the form of donations, government grants, volunteer labour and so forth. Using the governance criterion, one can distinguish between "mutual" and "entrepreneurial" non-profits. Mutual non-profits are ultimately controlled by their patrons, be they individual donors/customers or funding agencies, through voting rights or other means. Entrepreneurial non-profits, by contrast, are relatively unencumbered by formal patron influence, typically having centralised decision-making structures and/or self-perpetuating boards of directors.

Using this system of classification, the Wexford Festival Opera could be described as a private, entrepreneurial non-profit institution.<sup>1</sup> As seen earlier, it relies on both donative and commercial income: commercial income is from sales of tickets, sponsorship and other relatively minor trading activity; donative income is primarily from the state, but individual donations, both in kind and money terms, are significant. Does the disparate, extensive and often interdisciplinary literature on the theory of non-profits have any light to throw on the operation of such an organisation?

1. Under the terms of its trust, the Festival is legally prohibited from having a share capital and must submit audited accounts concerning the use of its funds to a board of trustees. Responsibility for the Festival rests entirely with the Council: there is no formal method by which its members can be held accountable to patrons, private or public.

### III MODELS OF NON-PROFIT ORGANISATIONS<sup>2</sup>

The previous section has highlighted the non-distribution constraint as the primary defining feature of the non-profit institution. The continued dominance of this organisational form in certain key areas would seem to imply some type of comparative advantage attributable directly to the non-distribution constraint. Despite difficulties such as limited access to capital and poor incentives for managerial efficiency, non-profits may, under the right conditions, perform functions that make them the optimal mode of service provision. What are these functions and why have they proved more important in some areas than others?

Weisbrod (1977) suggested that non-profit activity in many cases could be viewed as extra-governmental provision of public goods, financed by voluntary contributions from individuals dissatisfied with the prevailing level of state provision. In the absence of a Lindahl tax system equating tax shares with marginal benefits, individuals will demand very different quantities of even a single public good, whereas the government must choose a specific output level, thereby creating at least some excess demand. Thus, under for example a median voter system, all supramedian voters would demand a greater level of provision. To the extent that non-profits can target those voters in their fund-raising promotions and attract donations from them, they may be able to cater for at least some of this excess demand.

It was not made clear by Weisbrod why this excess demand for public goods must be catered for in the non-profit as opposed to the proprietary sector. Besides, the relevance of his theory to the high-culture sector is limited as private donations invariably come from attenders at arts events, suggesting that the donations are related to the private and not the public benefit. In the case of the Wexford Festival, however, there is a substantial state donation and as such the theory may have some applicability.

Hansmann (1980, 1981) also attempted to explain the existence of non-profits in terms of market failure, but using a different approach to Weisbrod. He argues that non-profits predominate in those areas where, owing to contract failure caused by informational asymmetries between provider and buyer, profit-seeking incentives would not be consistent with consumer welfare. Such contract failure is nearly always present in transactions involving donations. Thus in the case of Weisbrod's privately-financed public goods, although donors can determine the total output of the public good in question, they cannot, without information on all contributions, determine the impact

2. For a review of the relevant literature, see various articles in Powell (1987), particularly those by DiMaggio, Hansmann and James. See also Ben-Ner and Hoomissen (1991), James and Ackermann (1986) and Weisbrod (1987).

of their own individual contribution. Much the same applies to redistributive services such as providing foreign aid, where the purchaser of services (donor) cannot contact the ultimate recipient but must rely on the trustworthiness of an intermediary (charity) to ensure the service paid for is provided. Hansmann posits the non-profit institution as being uniquely placed to provide such trust because of the legal ban on distributable profits, which removes the incentive for service providers to exploit their informational advantages.

This framework can also be applied to a situation, like the arts, where private donations are most often related to the private benefits of attendance rather than to some public good or redistributive consideration. Hansmann has suggested that such donations act as a form of voluntary price discrimination and that they will, for reasons mentioned above, only arise in the non-profit sector.

Donative financing is particularly important for opera because companies such as that at Wexford are often required to operate in an environment of unusually high fixed costs and limited demand, which can result in the demand curve lying below the average cost curve at all possible output levels so that no single price can provide enough revenue to cover total expenses. Although any such organisation would make a loss it is still possible, if benefits vary widely across opera goers, that the total benefits outweigh the total costs and that consumer welfare is adversely affected by the absence of an opera. One possible solution in this case is price discrimination by, for example, charging higher prices for better quality seats. Since, however, due to the limited size of most theatres price discrimination in this way is likely to be only partially successful, it may be simpler and more effective to encourage opera lovers to donate a sum of money related to how much they value a given performance over and above the ticket price (i.e., on the extent of their consumer surplus).

The important point is that in order to have access to donations the organisation must, on account of the presence of contract failure, take the non-profit form; hence the existence of so many non-profits in the high-culture sector. In other words, since donors will want some implicit assurance that their contributions are really needed and are not simply being funnelled into profits, the non-profit institution has a comparative advantage over proprietary enterprise in activities requiring donative financing. In the case of "popular" art forms, such as Broadway musicals and films, however, the existence of more favourable demand conditions makes any form of voluntary price discrimination largely unnecessary, thus explaining the absence of significant numbers of non-profit providers.

A simple example may illustrate the points made above. An opera company is confronted with the following cost/demand conditions for a given perfor-

mance: costs (assume all fixed) of £300,000, 9,000 type A attenders prepared to pay, at most, £25 to view this performance, and 1,000 type B attenders prepared to pay a maximum of £275. At either attendance level, price is less than average cost and a deficit is incurred, making proprietary activity, in the absence of effective price discrimination, unviable. Suppose, however, that the organisation happens to be non-profit, charges the lower price to all opera goers, and manages to obtain, on average, a donation of 20 per cent of each high-demanders consumer surplus. Total receipts (i.e., from ticket sales and donations) will now cover costs enabling the performance to proceed.

The above explains why opera companies should and do set prices at a level which maximise *total* and not box-office receipts. In the example looked at earlier, the organisation would forgo a price rise from £25 to £275, even though ticket receipts would increase, because in doing so total receipts (from tickets and donations) would decrease.

There is no guarantee, of course, that voluntary price discrimination will always lead to a sufficient increase in revenue to permit a production to pay its way. Much depends on the factors influencing the donors to contribute. In the United States and other countries the availability of tax incentives for contributions is undoubtedly one important factor (see Steinberg, 1991). More interesting for the purposes of this study is the extent to which donations are endogenously determined by the non-profit institution itself. James and Rose-Ackerman (1986) suggest non-profits do this by cultivating a sense of community among their donors through the formation of donor clubs thereby partially excluding free-riders from the psychic benefits of donating. Moreover, by correlating benefits with contribution size some non-profits enable donors to "buy into" their output at different levels. Social pressure can also be brought to bear by some non-profits, especially in religion and to a lesser extent the arts, and in this situation the donations can be viewed as the non-profit analogue of taxation.

One drawback of the theories discussed so far is that they only explain the existence of private donations, a major source of direct funding for the non-profit sector in the United States. In Europe, however, there is usually only one large donor, namely the state. James (1987) has attempted to explain this phenomenon using a reformulated version of Weisbrod's model. The essence of her theory is that non-profits typically produce quasi-public goods (i.e., goods having public and private aspects), examples of which are to be found in the health, education and arts sectors.

Although non-profit development in some countries appears to be a response to excess demand for such goods, James's empirical work leads her to conclude, in contrast to Weisbrod, that in industrialised nations *differentiated* demand is much more important than excess demand, mainly due to

ethnic, religious and cultural differences. Although these quasi-public goods are provided by the state, in many countries governments prefer to donate venture capital and operating funds to non-profit providers, thereby enabling that sector to supply them. James (1987) explains this by arguing that there are distinct advantages to the government in so doing. First, a major potential advantage of private sector provision is that this often permits reliance on voluntary payments, thereby revealing and implementing people's preferences and reducing the necessary amount of taxation. A second source of comparative advantage for the private sector arises where product variety is possible, tastes are differentiated and economies of scale are relatively small. A third advantage with private provision of quasi-public goods, she claims, is that private institutions may be able to avoid the constraints on factor utilisation, wage floors and bureaucratic red tape which keep government costs high. The reason, of course, why the state will only make funding available to the non-profits relates to Hansmann's contract failure agreement, given the difficulty it would have in monitoring the use made of its funds by a small-service provider in the proprietary sector.

#### IV FUNDING STRUCTURE OF FESTIVAL<sup>3</sup>

In terms of Hansmann's categorisation of non-profits, the Wexford Festival falls between the two polar extremes of commercial and donative non-profit organisation. Around 70 per cent of the organisation's total revenue comes from commercial sources, the bulk of it from box-office receipts. The latter accounts for about 44 per cent of total receipts, with 3-5 per cent arising from other trading income (e.g., sales of programmes, recording rights) and 20-25 per cent coming from sponsorship income. Donations account for the remaining 30 per cent of receipts, the Arts Council grant making up about 23 percentage points of this and the rest coming from private donations.

The accounts do not, however, give an entirely accurate picture of the total support available to the Festival since there are at least three forms of *in-kind* donations that must also be taken into account. First, there is the volunteer labour aspect of the Festival. This component comprises not only the work of the Festival Council, an unpaid committee, but also parts of the Festival Choir and many of the backstage/front-of-house workers. Benefits are also obtained from sponsorship in kind of the Festival, such as free promotion and the provision of a variety of facilities at zero or very low cost. Finally, and most important, the Festival does not have to pay any of the labour cost of using the National Symphony Orchestra for the Festival,

3. For a description of the historical background, key features and organisational structure of the Festival, see O'Hagan *et al.* (1989).

although it does have to pay the subsistence costs of orchestra members. This clearly represents a large in-kind state grant to the Festival, greater in magnitude perhaps than that of the Arts Council.<sup>4</sup>

One task for non-profit theory is to explain the factors behind the development of this broad income structure. It is suggested below that the answer may lie in the constraints on box-office receipts facing the Festival. Two other components of the Festival's income, state grants and private donations, are examined in some detail, with particular attention being paid to possible rationales for, and determinants of, these revenue forms.<sup>5</sup>

### *Box-Office Revenue*

Income from ticket receipts accounts, as seen already, for less than half of total receipts. One factor constraining the level of box-office receipts is the small size of the Theatre Royal, the venue for the operas, which both limits total attendance and makes price discrimination by seat difficult to implement.<sup>6</sup> The former may not be a problem in reality as there is limited demand for rare opera anyway: the latter suggests that the application of Hansmann's theory of voluntary price discrimination may have some relevance.

Applied to Wexford, this theory would suggest that the Festival's length of run might be too short in relation to its fixed costs. If the Festival is characterised by high fixed cost and low variable production costs, then once one performance of a given production takes place the addition of an extra one will not substantially raise total costs, but will contribute much to revenue if the theatre can be filled for the additional night. Under relatively high fixed costs, therefore, a long run will enable total outlays to be recouped from box-office revenue, whereas a short run may result in a deficit. The problem for high-culture enterprises such as the Festival is that demand may not be sufficient to justify extra performances, making earned-income deficits unavoidable.

Using the annual financial accounts of the Wexford Festival it is possible to obtain a rough estimate of the relative magnitude of the fixed-cost element in total expenditure. Using a breakdown of this expenditure by category, three items of expenditure may be classified as largely fixed-cost whereas the

4. The value of this in-kind grant depends critically on what assumptions are made concerning the funding and operation of the National Symphony Orchestra and as such can vary significantly.

5. Income from sponsorship is not examined, even though it is significant in the case of Wexford. If this income, however, is treated simply as promotional expenditure by the companies concerned, it does not raise any particularly interesting issues of direct relevance to the discussion in the paper.

6. Different prices are charged for different nights of the week, but for any given night the same price is charged for all seats.



remainder covers variable-cost items such as artistic fees and orchestra expenses. Taking the ratio of these fixed to variable costs it transpires that, on average, fixed costs absorb almost two-thirds of total costs (see Table 1), a very high proportion of the total.

Table 1: *Percentage Allocation of Festival Expenditure by Broad Cost Category*

<i>Cost</i>	<i>1984</i>	<i>1985</i>	<i>1986</i>	<i>1987</i>
<i>Fixed</i>				
Staging	18.9	17.6	24.0	20.3
Administration	25.4	26.0	22.5	21.6
Labour	17.1	17.0	17.7	17.1
Total	61.4	60.6	64.2	59.0
<i>Variable</i>	38.6	39.4	35.7	41.0
Fixed/Variable	1.59	1.54	1.80	1.44

*Source:* Annual Financial Accounts, Wexford Festival Trust.

Relatively high fixed costs on their own, as seen already, are not the problem. West End musicals and films, for instance, have large set-up costs, but the potential demand is such that they have a realistic chance of recouping their initial losses and earning a profit. There is no direct evidence on the potential demand for opera at Wexford, although it is clear that a very large expansion of audiences would be required for full box-office financing to occur. One notable feature of Festival audiences is that they tend to be composed of the same individuals over a number of years, with many opera goers having a long history of attendance, a survey in 1988 showing that over 40 per cent had attended on more than ten occasions in the past (see O'Hagan *et al.*, 1989). While the Festival benefits in one way from this unusually high degree of customer loyalty, it may indicate that the Festival is tied to a particular audience-type, and that it would be difficult to attract many new attenders.<sup>7</sup>

Why it may be asked, then, does the Festival not raise prices? One reason is that it may reduce donations and thereby, perhaps, total receipts (see Section II). Much more important, however, is the context in which the Festival operates. Because its success depends on its ability to attract British

7. It must be noted, however, that the increase in seating capacity by 20 per cent and the increase in the number of times each of the three operas of the Festival are performed, from four to six, in recent years almost doubled the number of tickets for sale without any drop in seat occupancy rates. This increase in the number of tickets sold, though, was achieved through an extensive marketing campaign and it is unlikely that any further substantial increase in demand could be achieved.

visitors, the Festival is constrained from charging significantly higher prices than its competitors in Britain and Europe, especially in view of the high transport costs that foreign visitors must incur. Most of these competitors have a much higher level of public funding than Wexford, thereby enabling them to offer seats at prices that cover only a fraction of total expenditure. Although the Festival's emphasis on rare and small-scale opera gives it a special niche that reduces direct comparison with its competitors and reduces total costs, it is still unlikely that prices can diverge much from those being charged elsewhere without losing audience support.

### *Individual Donations*

Donations take the form of either membership fees for the Friends of the Festival Society or are made at the time of booking. The fact that donations come predominantly from regular attenders would seem to confirm Hansmann's argument that they represent payment for a better-quality Festival, especially since such payments are obtained in the context of appeals to allay deficits.

The existence of the Friends of the Festival Society is consistent with the "buying-in" theory. Friends receive certain benefits not available to ordinary festival attenders. The tangible benefits include priority booking, three newsletters a year, and tickets for various events such as a pre-Festival lecture on the operas, a post-Festival reception and so on. The intangible benefits of club membership may be even more important: a feeling of being a part of the Festival and the possibility of the Friends acting as a source of contact. The publication of the names of all donors in the Festival programme creates psychic benefits in terms of social recognition and prestige and may act as a spur to others to donate.

There is little doubt that the existence of the Friends Society serves to reduce free-rider incentives and encourage donations. Individuals seem to be more willing to donate when they themselves benefit in some way, even if the costs appear much greater than the actual benefits. Income from Friends has increased significantly as a proportion of total receipts in the last ten years, partly because there was a large rise in the membership fee and partly because the number of Friends increased significantly, despite the hike in fees.

### *State Funding*

If the Festival relied exclusively on a combination of box-office revenue and donations, then it might lend considerable support to Hansmann's explanation for the non-profit arts institution. It would be possible to argue that the Festival is non-profit because it needs to attract donations to cover earned-income deficits and because such donations are subject to contract

failure. The use of other income forms besides these, however, makes such an explanation somewhat harder to sustain. Undoubtedly, the greatest obstacle to Hansmann's theory is the importance of public funding to the Festival.<sup>8</sup>

Hansmann (1981) has, however, provided a different rationale for public funding of an arts enterprise which has the advantage of being consistent with his voluntary price discrimination theory. Where non-profit arts enterprises are practising voluntary price discrimination, government grants may still be justified on efficiency grounds if free-rider problems have reduced donations below their optimal level. Such free-rider incentives are likely to be present to at least some degree because all opera goes at a given performance benefit from the increase in quality financed by those attenders who choose to donate. If fundraising promotions, social pressure, or donors' clubs are not creating enough donations to cover deficits, and if the private benefits are believed to be greater than total costs of production, efficiency considerations would suggest some public subsidy from tax revenue. The main drawback to this rationale is that it creates a conflict between equity and efficiency, since it implies that the general taxpayer should subsidise an arts-attending minority, most of whom are from the higher-income groups in society. It would be difficult to apply this argument to the Festival in any case, since the small size of individual donations in relation to government grants would imply either free-riding on a massive scale or, much more likely, that private benefits do not outweigh total costs.

The only plausible case, in fact, for state funding seems to be one based on James's quasi-public goods argument. O'Hagan (1992) has argued that there are benefits arising from the Festival that are essentially quasi-public in nature. One possible type of public benefit relates to the Festival's contribution to tourism in the Wexford area and the consequential beneficial effects on local employment and income (see O'Hagan *et al.*, 1989). Other benefits might arise from the considerable international prestige associated with the staging of an event such as the Festival, which is often claimed to be valued by a country's citizens in general, irrespective of whether they are regular arts patrons or not.

Obviously the Festival's early funding by Bord Fáilte was related to tourism considerations, whereas Arts Council grants and the involvement of the National Symphony Orchestra would appear to be based on the second type of benefit. The state could, of course, opt for quasi-public good provision via public enterprise, charging market prices for tickets and subsidising the resultant deficits out of tax revenue. Provision of the arts by public or quasi-governmental enterprises is common in France and Germany, where many

8. Prior to the 1970s the state grant came via Bord Fáilte (the state tourism board), whereas since then it has come from the Arts Council.

theatres and opera companies are owned and controlled by municipal and state authorities. The cost and other arguments outlined by James, however, suggest that provision by, and subsidisation of, the non-profit sector will be preferred in situations like Wexford, especially given the existence of considerable contributions from private donations and volunteer labour.

## V CONCLUSION

A non-profit organisation is one whose profits, or more precisely net earnings, are not legally distributable to controlling individuals. This paper has sought to draw attention to a small part of the economic research now available on this organisational form and to assess its potential application to a specific non-profit performing-arts enterprise in Ireland. Does the theory have any important contributions to make in this regard? The evidence appears mixed.

On the one hand, non-profit theory does not satisfactorily incorporate the rôle played by government in funding non-profit institutions, and therefore must have limited relevance to many European arts institutions. Another problem is that many individual non-profit institutions cannot be explained without reference to their origin, Wexford being a case in point, and there is little light that theory can throw on this aspect of non-profits.<sup>9</sup> The greatest difficulty is that there does not appear to be any overall coherent theory of non-profits and many of the theories that do exist extend little beyond fairly simple common-sense reasoning.

On the positive side, the theories do provide a useful framework for thinking about non-profits. Moreover, Hansmann's theory of voluntary price discrimination can explain some features of an arts institution such as the Festival. For example, it directs attention to the unusual cost and demand conditions surrounding opera production, conditions that may account for the financial difficulties that have tended to be a persistent feature of the Festival. In addition, the existence of the Friends organisation, general donations and a large volunteer labour input would suggest that some form of implicit price discrimination is taking place, although provision of free labour services may be motivated by other considerations as well (see Menchik and Weisbrod, 1987, and Weisbrod, 1988). Finally, the theory throws some light on why the Festival is non-profit rather than proprietary in form and on why in this case the government favours grants in preference to direct provision.

9. The driving force behind the formation of the Wexford Festival Opera was Dr Tom Walsh, without whom almost certainly there would be no festival today. See James and Rose-Ackerman (1986) for some discussion of the rôle of pioneering individuals in establishing non-profit institutions.

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