Allocating Excess Revenue for a Fine Arts Nonprofit

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Introduction

Many cultural organizations possess nonprofit status for a variety reasons. These explanations include the high start up costs associated with establishing a fine arts company, the federal tax exemption the nonprofit receives, and the signal that the nonprofit status conveys. The nonprofit signal implies that an organization is trustworthy which in turn, encourages donations. Unlike for profit firms, nonprofit organizations receive unearned income through donations and government subsidies. Sometimes, a nonprofit receives funds that exceed its costs. This can occur for a variety of reasons including receiving an unexpected, one time surplus. An example of unexpected surplus is an unforeseen, large donation. However, due to the non-distribution constraint legally enforced upon nonprofits, a nonprofit cannot distribute its net earnings to individuals who over see the company. Instead, a nonprofit must allocate the extra funds back into the program. Interestingly, economic literature has not examined how a fine arts organization spends excess income. While this event is rare, that does not mean a fine arts nonprofit never generates a surplus.

This paper explores the possible areas where a fine arts nonprofit can invest after receiving an unexpected, one time surplus. The specific options discussed include staff training, putting into the endowment, increasing acquisitions, lowering ticket prices, increasing output, and raising wages. Furthermore, this paper investigates the expected impact on attendance of increasing acquisitions, lowering ticket prices, and increasing output, by analyzing the elasticity of demand for the fine arts sector. Similarly, the elasticity of the labor supply in the fine arts sector is also examined in order to predict the impact of raising wages.

Literature Review

First and foremost, it is important to understand why most fine arts organizations are nonprofit. Hansmann (1981) explains that many preforming arts groups have high fixed costs and low marginal costs relative to its market demand. He argues that price discrimination (without subsidy), more specifically voluntary price discrimination, may be necessary for their operations. Voluntary price discrimination is unique to nonprofits and according to Hansmann, this is the underlying reason why most fine arts organizations possess nonprofit status. The nonprofit status provides the signal that the organization is trustworthy, inducing donations, and the deductibility makes the price of a donation lower and thus, increasing donations. Although price discrimination is a key to the success of fine arts nonprofits, they also receive other benefits that profit-seeking companies do not.

A nonprofit is unique in the sense that it receives unearned income through grants and contributions from a variety of sources. These sources include governments at the local, state, and federal levels, as well as foundations, individuals, and businesses. It is important to note the significance of earned income in a nonprofit's revenue. Earned income includes admission prices, touring and institutional fees, unrelated business activities (for example, concessions, gift shops, etc.), and investment income (McCarthy, Brooks, Lowell, and Zakaras, 2001). Specifically, in 1997, a U.S. Census Bureau survey reported that on average, earned income contributes about 59% of nonprofit performing arts' revenue and unearned income makes up the remaining 41%. Unearned income can be broken down more specifically with 15% coming from individuals, 7% businesses, 7% foundations, 7% other, 4% other government, and 1% National Endowment for the Arts (NEA).

Light (2004) argues that a nonprofit will best sustain itself by investing in capacity building. He found that the four most popular definitions of success among his sample of 318

executive directors were efforts improving programmatic impact, efforts improving organizational management, efforts producing long-lasting impacts, and efforts increasing productivity. He states that "successful capacity building involves an effective strategy for change, which leads back to funding, measurement, outside contact, and planning."[1] However, he also argues that there isn't a "one-size fits all" strategy to effectively and efficiently allocate a nonprofit's revenue. He expresses that these methods should be implemented accordingly for each individual nonprofit's venture.

Specifically for the performing arts, McCarthy, Brooks, Lowell, and Zakaras suggest that nonprofits should invest in producing blockbusters as well as familiar, traditional programs because blockbuster productions help generate revenue. They also advise that combining primary programming with the sale of supplementary products (for example, t-shirts) is another means of receiving more revenue. Their remaining revenue generating suggestions include increasing the number of performances of the same production, maximizing the audience per performance by performing at larger venues, and targeting niche markets that have predictable, loyal audiences.

Jeffri (1980) believes that measures should be taken to improve management. Specifically, she suggests that a nonprofit should invest in management training and the importance of finding an appropriate successor to an organization's current management in order to continue the growth and expansion of the program. She also discusses the importance of creating a model that does not isolate the arts by discipline. She believes that creating a cooperative model will strengthen the nonprofits' support structure.

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[1] Light, Paul C. *Sustaining Nonprofit Performance: The Case for Capacity Building and the Evidence to Support It.* Washington, D.C.: Brookings Institution, 2004. 175. Print.

Although these authors differ in where they believe a nonprofit should invest its revenue, they all agree that where a given fine arts nonprofit receives its income affects how it spends its revenue. In other words, they believe that if an organization experiences a shift in its sources of income, (for example, individual donations increases, but government support decreases) that shift will cause a change its spending behavior. Although this is a rational hypothesis, it is not supported empirically.

Hughes and Luksetich (2004) find that the sources of revenue do not influence a fine arts nonprofit's spending practices. They divided their sample into three categories: (1) museums, (2) performing arts, (3) media and communications (although the latter is not of interest for this paper). Their sample includes 101 museums ranging from art, history, natural science, science and technology, and children's museums as well as 57 performing arts organizations. The performing arts category includes performing arts centers, dance and ballet troupes, theaters, operas, music, bands, ensembles, and symphony orchestras. The sample consists of larger nonprofits that filed IRS Form 990s between 1987 and 1996. They categorized revenue sources as direct public support, indirect public support, government contributions, program service revenue, membership dues and assessments, and other revenues (interest, dividends, rent, and other investments). They test four nonprofit expenditure patterns: program service, management, fundraising, and excess revenue. They find that museums typically distribute revenue increases into asset balances regardless of their source. Similarly for performing arts organizations, their analysis found that nearly all revenue increases flow into increasing net asset balances. They note that asset balances are eventually spent largely on program services, less on management, and even less on fundraising. Their results do not support the popular notion that if a nonprofit becomes more reliant on a private funding sources, then the pursuit of funding will undermine of

the delivery of service that defines that given nonprofit's mission. Although the sources of income do not affect the operations of a nonprofit, it is important to investigate where a nonprofit can receive the most benefit from its investment.

The Options

Staff Training

Staff training is one area in which a fine arts nonprofit can allocate its excess income. After undergoing training, employees accumulate more human capital. It is also common for an employee's wage to increase after training. Staff training also benefits the company. In the long run, investing in staff training improves a worker's marginal productivity of labor. Assuming the staff training is in fact effective, an area of interest for a fine arts nonprofit is allotting excess revenue to staff training to those who work in the fundraising department. As stated in the Literature Review, unearned income is an important source of revenue for all fine arts nonprofits. If those responsible for encouraging individuals, foundations, and businesses to donate to the organization become more productive, this should lead to more donations and/or larger donations. Thus, continuing to benefit the nonprofit into the future.

Putting Into the Endowment

The mission of an endowment varies between each fine arts organization. For instance, the Lourve's endowment is set up to finance the museum's long term investments, whereas the mission for the Nelson-Atkin Museum of Art is to provide educational programs and

various other outreach activities.[2] [3] Regardless of the specific mission, endowments are typically created to help the fine arts nonprofit reach its larger objectives. Therefore, investing excess revenue back into the endowment benefits the organization into the future.

Increasing Acquisitions

A fine arts nonprofit can devote excess revenue to securing more acquisitions. Specifically, if a museum acquires more paintings, a museum can expand and diversify its collection. For example, if a museum only has impressionist paintings, it can now invest in acquiring surrealist paintings. This kind of expansion has a number of consequences. One, diversifying an organization's acquisitions creates more opportunities for attendants to learn new information that they then can share with their friends and family. In other words, expanding a company's acquisitions creates a knowledge spillover effect that in turn, benefits the community. Secondly, diversifying acquisitions attracts new attendants and as a result, opens the museum to more possible donors and thus, benefits the organization into the future. However, how many more attendants the institution receives in response to increasing acquisitions depends on the elasticity of demand.

Lowering Ticket Prices

Using the excess earnings to lower ticket prices (specifically for one fiscal period) would increase the organization's accessibility. In other words, more people who were unwilling to pay the company's previous admission fee are now willing to attend. Similarly to increasing

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[2] "The Louvre Endowment Fund." Site Officiel Du Musée Du Louvre. Web. 28 Feb. 2013. <http://www.louvre.fr/en/louvre-endowment-fund>.

[3] "Support the Museum- Endowment." *The Nelson-Atkins Museum of Art*. Web. 28 Feb. 2013. <http://www.nelson-atkins.org/support/Endowment.cfm>.

acquisitions, this increased accessibility expands the organization's potential donor pool and thus, can continue to benefit the nonprofit into the future. Lowering ticket prices also generates positive externalities. Suppose a museum lowers its admission fee, and as a result more people attend the museum. If more people go to the museum, then there will be more individuals learning from the cultural experience provided by the museum. If more people become educated, then there are more individuals able to share their ideas with their friends, family, and the community. In other words, similarly to diversifying an organization's acquisitions, increasing a nonprofit's accessibility creates a knowledge spillover effect. This creates a more knowledgeable community. Like increasing acquisitions, the quantity of new attendants due to the lowering of ticket prices depends on the elasticity of demand.

Increasing Output

A fine arts nonprofit can use excess revenue to increase its output. However, it is important to note that the concept of output is different in a fine arts context. For example, increasing output for a museum could mean expanding its hours of operation or keeping a special exhibit there for longer. On the other hand, increasing output for a performing arts organization could mean increasing the number of shows or adding a new performance. Increasing the number of shows, expanding the hours of operation, and keeping a special exhibit for longer will provide the consumer more opportunities to attend. Like lowering ticket prices, this creates positive externalities including the knowledge spillover effect. Adding a new kind of show will diversify the organization and will have similar consequences to that of increasing acquisitions. In accordance with both lowering ticket prices and increasing acquisitions, the impact of increasing output depends on the elasticity of demand.

Raising Wages

A fine arts organization can also use excess revenue to raise wages in order to attract more qualified workers. In the fine arts context, workers are considered to be artists. By attracting more qualified or more prestigious artists, a nonprofit can attract more customers. Similar to increasing acquisitions, lowering admission fees, and increasing output, this creates a knowledge spillover effect and also exposes the organization to more potential donors and thus, assisting the nonprofit into the future. However, the impact of raising wages depends on the elasticity of the labor supply in the fine arts sector.

Analysis

The Elasticity of Demand

Although a given fine arts may have different reasons for lowering admission prices, increasing output, or increasing acquisitions, the magnitude of each choice depends on the organization's elasticity of demand. In other words, while lowering ticket fees, adding output, and increasing acquisitions are clearly three separate choices; the impact on attendance for all three decisions relies on the elasticity of demand. Generally, the fine arts sector is regarded as having a relatively inelastic demand. However, elasticities do vary between organizations and thus, it is important to look at each type of arts organization. Museums are firstly examined followed by analysis of the performing arts' demand elasticities.

Typically, museums have an inelastic demand. Frey and Meier (2003) analyze both the private demand of various museums including zoos, science, natural history, and art museums. In general, their research suggests that all museums have relatively low elasticities of demand. Furthermore, out of all types of museums, it appears that art museums have one of the lowest

elasticities with an average of -0.17.[4] While performing arts organizations as a whole are also considered to have an inelastic demand, the research is more thorough and complex when analyzing and comparing across categories and individual companies.

Similarly to museums, most economic research implies that the elasticity of demand for the performing arts is relatively inelastic. Furthermore, most scholars, including Lange and Luksetich (1984), suggest that a smaller orchestra typically has relatively higher demand elasticity than that of a larger orchestra. A similar pattern is observed when comparing the elasticities of smaller performing arts organizations with larger ones. Both the above conclusions correspond with Felton's (1992) results. However, Felton dives further with her analysis by examining 24 different orchestras' data from 1979 to 1987, 14 different ballet companies' data from 1982 to 1987, and 12 different operas' data from 1979 to 1985.[5] She organizes these companies into various categories based on type, budget, and/or location. Felton preforms various ordinary least squares regressions on her data and her results yield perplexing conclusions.

Felton discovers that not only did demand elasticities vary between categories as expected, but she also recognizes that elasticities fluctuate within groups. For example, Felton finds great variation between the five companies categorized as "mega-orchestra" (orchestras with a concert income of at least $9 million during the 1987-88 season). Specifically, the New York Philharmonic symphony orchestra produces an elasticity of -1.18, whereas the San Francisco Orchestra generates a demand elasticity of just -0.10.[6] (Although the minus sign is

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[4] Frey, Bruno S., and Stephan Meier. *The Economics of Museums*. Working paper no. ISSN 1424-0459. University of Zurich, 2002. 4. Print.

[5] Felton, Marianne V. "On the Assumed Inelasticity of Demand for the Performing Arts." *Journal of Cultural Economics* 16.1 (1992): 1-12. Kluwer Academic Publishers. 4. Web. 1 Nov. 2012.

[6] Felton, Marianne V. 10.

typically dropped, Felton includes the minus sign because some companies have positive elasticities. This result is investigated further in the paper.) One would anticipate to find similar demand elasticities within a given category whether it be organized by genre, budget size, and/or location. However, based on Felton's research, this does not appear to be the case. Furthermore, Felton recognizes that basic economic theory does not correspond with her results.

Not only is there significant and unexpected variation of elasticities within categories, certain companies also generate elasticities that are contradictory to fundamental economic theory. In other words, neoclassical economic theory appears to be insufficient in explaining some of Felton's results. Many of the organizations in Felton's sample size yield positive demand elasticity. This result challenges the law of demand. Felton notes that a few organizations with positive demand elasticities have insignifican coefficients. This suggests that "price is of little importance compared with other considerations such as available leisure time and expected quality." [7] However, this explanation does not apply to companies who generate positive elasticities with significant coefficients. This result illustrates the concept that a consumer often interprets price as a measure of quality. In other words, it is possible that a customer believes that if a good is expensive, that it must be a high quality product. Sometimes, this perception can be so strong that it causes the demand elasticity to be positive. An equally bizarre result occurs in Felton's research when comparing individual fine arts organizations with one another.

While some performing arts companies generate unexpected, positive demand elasticities, the most troublesome results are those that explicitly contradict widely accepted determinants of

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[7] Felton, Marianne V. 10.

elasticity. Specifically, economists agree that the availability of substitutes and the size of the expense in proportion to one's income are both determinants of elasticity. Based on these widely accepted theories, one would expect to find relatively higher elasticities for the performing arts in larger cities. However, Felton finds the exact opposite to be true in her analysis. For example, the orchestra in Winston-Salem, North Carolina has an elasticity of -1.21 while Chicago's orchestra, which is located in a city over seven times larger than Winston-Salem, generates a demand elasticity of only -0.24.[8] [9] However, it is important to note that these two orchestras are from different expense groups. Still, this unexpected result is found even when examining different organizations in the same budget category. For example, both orchestras in Seattle and Dallas are categorized under the same expense group. Since Dallas is almost twice the size of Seattle, economic theory suggests that Dallas would have the relatively more elastic demand.[10] However, Seattle's orchestra yields a demand elasticity of -1.20, whereas Dallas' orchestra generates a demand elasticity of -0.88.[11] This appears to be a consistent pattern in Felton's results. Felton attempts to legitimize these results by attributing them to consumer loyalty. In other words, Felton implies that certain performing arts organizations in larger cities have devoted followers and thus, generate a relatively lower elasticity of demand. Although these results were not predictable, they give insight to the complex nature of the performing arts sector.

While as a whole, the fine arts sector has a relatively inelastic demand, the companies that make up this sector have varying elasticities. In attempts to find a cohesive pattern or theme in their elasticities, various performing arts organizations were categorized based on type, budget,

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[8] Felton, Marianne V. 11.
[9] "Top 50 Cities in the U.S. by Population and Rank Read More: Top 50 Cities in the U.S. by Population and Rank." Infoplease. Web. 1 Mar. 2013. <http://www.infoplease.com/ipa/A0763098.html>.
[10] "Top 50 Cities in the U.S. by Population and Rank Read More: Top 50 Cities in the U.S. by Population and Rank."
[11] Felton, Marianne V. 10.

and location. However, this method did not clarify the irregular elasticities. Often times, organizing the companies only raised more questions. These strange results are justified by unconventional, behavioral economic reasoning. On average, the fine arts sector has a relatively inelastic demand. This implies that accumulating more acquisitions, lowering ticket prices, and increasing output has a relatively small impact on attendance. While the fine arts sector as a whole has a relatively inelastic demand, it is possible that accumulating more acquisitions, lowering ticket prices, and increasing output would generate a relatively large increase in attendance if the organization has a relatively elastic demand. As Felton's research shows, this is possible since there is so much variation in elasticities across companies. For example, lowering ticket prices for the New York Philharmonic would have a relatively large impact since it has a relatively elastic demand as discussed earlier. However, the predicted impact on attendance from lowering ticket prices for the San Francisco Orchestra is much lower since it generates a demand elasticity of only -0.10. Clearly, there are significant variations in elasticity between categories and individual organizations. Thus, there is varying degrees of impact on attendance that accumulating more acquisitions, lowering ticket prices, and increasing output would have on a fine arts nonprofit.

The Elasticity of the Labor Supply

The elasticity of the labor supply determines the impact increasing wages would have on a given fine arts organization. That is to say, if a given fine arts company decides to raise wages, the magnitude of that choice depends on the elasticity of the labor supply. The supply of labor in the fine arts sector is unlike that of a typical labor market. A laborer in the fine arts sector is considered to be the artist. It is even difficult to define who an artist is. Throsby (1994) defines an artist, whether it be an actor, a musician, a painter, or a poet, as an individual who possesses

"the willingness or capacity... to sell their artistic labor or its immediate products."[12] Furthermore, he makes a distinction between performers and creative artists. Performers are considered to be actors, musicians, and dancers. On the other hand, creative artists are considered to be individuals who make products for sale such as painters, sculptors, craftspeople, writers, and composers. Creative artists usually work independently and are often self-employed. On the other hand, performers are typically temporary employees without job security when they work for money. Despite these differences, both creative artists and performers have similar working habits that are unique to the cultural labor force.

Understanding the elasticity of the labor supply in the fine arts first requires knowledge of how the fine arts labor market operates. This particular labor market behaves in a different way than most other labor markets. First, artists invest a lot of time into their creative work, including many hours that are unpaid. For example, often times a performer practices to maintain and advance his/her skill. On the other hand, a creative artist spends time and effort producing a masterpiece that is not for sale. These are two examples of an artist's unpaid work. Therefore, a typical artist is unable to earn a living wage on his/her creative work alone. As a result, many participants in the fine arts hold multiple jobs in order to maintain a living. After analyzing multiple surveys, Wassall and Alper (1992) found that 76 percent of artists hold non-artistic jobs. They also observe that an artist typically gains more job security the older he/she gets. This can be due to a variety of reasons including improving his/her art from accumulating more hours devoted to creative growth or because successful artists are exiting the market. Furthermore, Throsby (1992) notes that from his sample of Australian artists, most of them supply non-artistic

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[12] Throsby, David. "The Production and Consumption of the Arts: A View of Cultural Economics." *American Economic Association* 32 (1994): 1-29. *JSTOR*. 16. Web. 22 Jan. 2013. <https://www.jstor.org/stable/2728421>.

labor only up to the point where a sufficient return is attained in order to support their primary artistic work. Similarly, Jeffri (1991) surveyed over a thousand American painters and about 70 percent of them had turned down profitable opportunities that did not appear to be artistically satisfying. From these statistics, it seems that while many artists work multiple positions (often times jobs that are not artistically related) to maintain living, a typical artist is willing to sacrifice a relatively greater income for creative growth. These unique characteristics affect the earnings function of a typical artist.

Due to the uncommon behavior found in the fine arts labor market, an artist's earnings function is unlike that of most occupations. In order to understand an artist's earnings function, it is necessary to separate art related income from non-art related income. It is known that a determinant for an individual's earnings profile is the cultivation of human capital. At first sight, an artist does not appear to have a substantially lower income than that of an average worker, especially when using an artist's total (art and non-art) income. In 1990, the median weekly earnings for a full-time wage and salary earners in the United States was $415 and that of a full-time artist was $499.[13] However, Throsby discovers that artists' have significantly lower levels of mean and median earnings compared to other workers with similar educational and professional standing. As stated earlier, the median weekly earnings for a full-time artist was $499 in 1990. However, the median weekly earnings of a full-time managerial and professional worker was $608 in that same year.[14] (It is also important to note that in that census, the artist's income was not isolated from artistic and non-artistic income.) Both the artist and the manager have similar educational backgrounds and yet, the artist receives substantially less income. This

[13] Throsby, David. 18.
[14] Throsby, David. 18.

implies that the amount of education, a common economic measure of human capital, is not as influential in determining an artist's income as it is in other labor markets. A couple more interesting characteristics of an average artists earnings profile is the steep increase in income as an artists becomes older as well as the importance of talent. Talent is a difficult thing to measure, but it is viewed as being an imperfect substitute. With this information, it is now possible to determine whether or not the labor supply is relatively elastic.

There are many labor supply elasticity determinants including relative wages, relative training/skills, the transferability of training/skills, non-wage benefits, and the weekly hour requirements. Typically, if an occupation offers a relatively low wage, the labor supply tends to be more elastic. In that sense, the labor supply of the fine arts is elastic. However, most other characteristics found in this labor market correspond with that of an inelastic labor supply. For instance, the training and skills required to be an artist are high with talent as an imperfect substitute. Furthermore, most artists have comparable educational and professional backgrounds as those who hold managerial or professional jobs. This implies that the labor supply is relatively inelastic. Secondly, most artists work non-artistic jobs in order to maintain a living. This implies that artistic skills are not particularly transferable to other labor markets and thus, suggests that the fine arts labor supply is relatively inelastic. Also, it is known that most artists leave their non-artistic job once they earn enough income to maintain an adequate lifestyle and continue to focus on their creative work. Furthermore, most artists reject job offers with greater predicted earnings if they do not find the work to be artistically fulfilling. Both of these characteristics suggest that artists find there to be large non-wage benefits to their career. Similarly, this characteristic also implies that the labor supply is relatively inelastic. Lastly, as discussed earlier, artists invest a lot of time into their creative work, including many of hours that the artist is not paid for.

According to fundamental labor economic theory, the more hours an occupation requires of its workers, the more inelastic the labor supply tends to be. Assuming that the combination of the four characteristics of the fine arts labor supply that suggest its inelasticity (high skill level, lack of training transferability to other labor markets, large non-wage benefits, and high weekly hour requirements) is greater than the magnitude of the one characteristic that implies that the supply of labor is elastic (relatively low wage), it can be concluded that the labor supply of the fine arts is relatively inelastic.

Conclusion

There are a variety of different areas where a fine arts nonprofit can invest excess income. The different options this paper discusses are staff training, investing into the endowment, accumulating more acquisitions, lowering ticket prices, increasing output, and raising wages. While the above list contains a wide range of options, there are other areas an organization can allocate excess revenue that this paper does not mention. This includes, but is not limited to using the surplus to cover a fiscal year in which the nonprofit generated a loss and updating technology. This paper also explores the expected impact of specific options by investigating the elasticity of both demand and the labor supply for the fine arts sector. While as a whole, the fine arts sector has a relatively inelastic demand, there are varying elasticities between groups and individual organizations. Therefore, it is possible that increasing acquisitions, lowering ticket prices, and increasing output would have a relatively strong impact on the quantity of attendants. Research also suggests that the fine arts sector has a relatively inelastic labor supply. This suggests that raising wages would not be a particularly successful method in attracting higher qualified artists. Obviously, an organization would like to allocate funds to an option with a large impact. However, there are other important factors that determine the best area of investment for

a fine arts nonprofit. These factors include the organization's risk management, future goals, and perceived benefits. For example, if a museum's mission is to be accessible to the community, lowering ticket prices would consistent with that goal, regardless of impact. It is also important to note that even if a decision does not have a relatively large predicted the impact, that does not mean it will not have any impact. Ultimately, the best or likely decision for a fine arts nonprofit depends on the organization's mission.

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