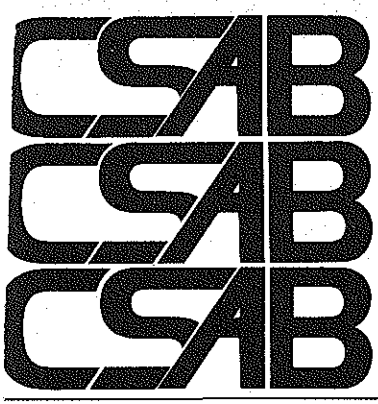

The Profits of Nonprofits:

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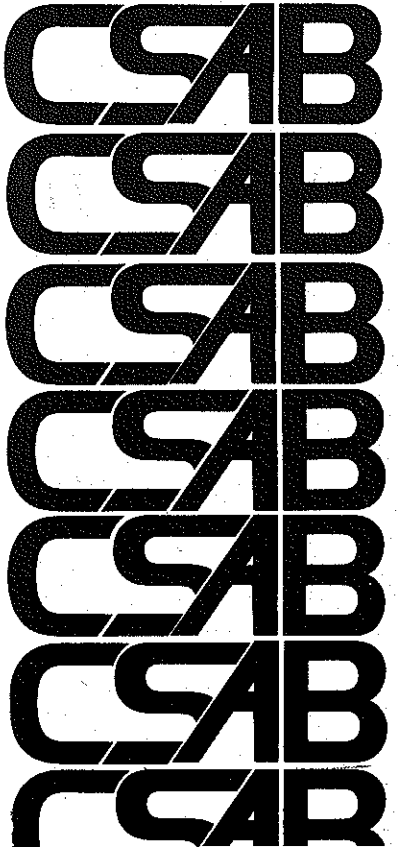
by Thomas J. DiLorenzo and James T. Bennett



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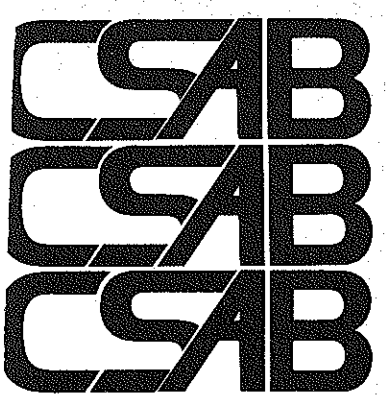

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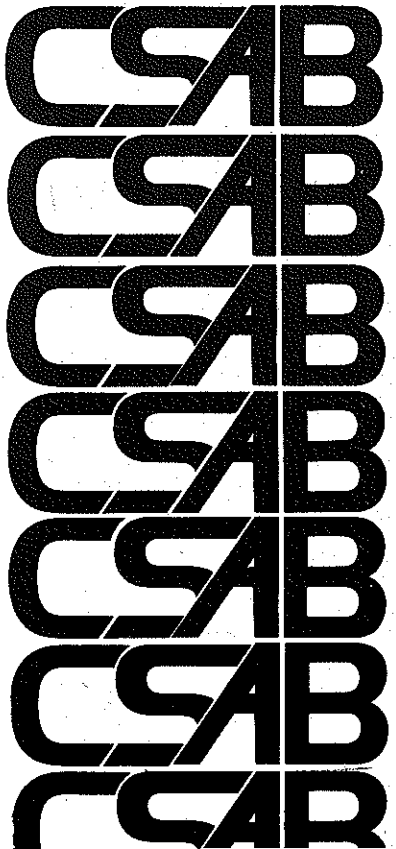

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Introduction

Governments at all levels appear to be promoting the development and expansion of the small business sector in the United States. The Small Business Administration (SBA), in general, and its Office of Advocacy, in particular, stand ready to foster the interests of entrepreneurs at the federal level. Two White House Conferences on Small Business have been held—one by the Carter administration and one by the Reagan administration. Many state governments have established agencies similar to the SBA and, under the aegis of their governors, have also sponsored conferences to enhance understanding of the concerns of small firms and promote statewide economic development. At the local level, chambers of commerce and similar organizations of businesses and professionals are widely perceived as being in close contact with government officials who are attuned to and concerned about small business issues.

As is so often the case, however, appearances can be deceiving. At the same time that government officials are publicly praising the contributions of small business to economic progress, government is actively engaged in unfair competition with small firms, both directly as a service provider, and indirectly by granting tax exemptions and giving taxpayer subsidies to (profit-making) "nonprofit" organizations. Thus, the commercial nonprofit sector—comprised of government enterprises as well as tax-exempt, but profit-making nonprofit organizations—competes unfairly with private businesses. Not infrequently, this competition is so intense and tilted in favor of the nonprofits that many firms have already been driven from the marketplace; others struggle to survive. Not only is competition from the commercial nonprofit sector damaging existing firms, but it also discourages the formation of new firms.

Private firms are at a decided disadvantage in competition with nonprofit enterprises. The latter pay no taxes; borrow at advantageous rates of interest because of the tax-exemption accorded to the debt instruments of state and local governments and their affiliated entities; are frequently granted low-interest, federally guaranteed loans; are not required to post bonds; are generally exempt from the regulations that impose enormous costs on private firms through compliance and paperwork; frequently receive direct subsidies from the taxpayer; and can solicit charitable contributions. Moreover, customers who are not satisfied with the services received from a nonprofit enterprise find it difficult, if not impossible, to obtain redress through the courts because nonprofit entities are often legally

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Dr. DiLorenzo is the John M. Olin Visiting Professor, Center for the Study of American Business, Washington University, St. Louis. He is on leave from George Mason University. Dr. Bennett is the William P. Snavely Professor of Economics at George Mason University. This report is adapted from a chapter of their forthcoming book *Unfair Competition: The Profits of Nonprofits.*

Among the most prominent innovations in the past decade that has also had a major impact on instructional techniques is the microcomputer, which, for our purposes, may be regarded as part of the audiovisual industry. Development, promotion, distribution, and sales of software for instructional use is a rapidly growing field serving the same customer base as the audiovisual industry. In many cases, software firms are small operations which often specialize in programs for specific applications, e.g., class scheduling or accounting systems for schools. The most important characteristic which the audiovisual and microcomputer industries have in common is that both are experiencing intense competition from the commercial nonprofit sector, particularly from tax-exempt educational institutions and government agencies.

The entry of colleges and universities into competition with private firms in the audiovisual industry is hardly surprising. Institutions of higher learning are not only intensive users of audiovisual materials, but they also may offer both undergraduate and graduate degrees in "communications" with a specialty in the development of such instructional materials. Faculty are readily available to provide production expertise as well as to develop program content.

The audiovisual and microcomputer industries are experiencing intense competition from the commercial nonprofit sector, particularly from tax-exempt educational institutions and government agencies.

A case can be made that the initial entry of educational institutions into the media market was unplanned and purely a matter of chance. Consider, for example, the founding of the Instructional Media Center at Michigan State University which rents and sells audiovisual instructional materials in direct competition with private firms.[3] From modest beginnings, the IMC at Michigan State quickly expanded into a commercial operation. The university's Board of Trustees approved the allocation of royalties: 50 percent to the authors, 20 percent to the academic department, and 30 percent to the university. With these arrangements in place, the university, itself a nonprofit, tax-supported organization, entered the market as a competitor enjoying the benefits of tax-exempt status as well as direct taxpayer funding.

Higher education was not facing budget exigencies in the late 1960s and early 1970s, so the marketing activities of IMC at MSU might plausibly be interpreted as an effort to provide a service to the academic community on a self-supporting basis. Thus, the competition offered by the nonprofit entity arose as a "natural" extension of its educational mission. The extent of the

Unfair Pricing in the Audiovisual and Computer Industries

When governmental grants and contracts finance research and development, the purchase of equipment, or provide personnel, facilities, etc., it is clear that commercial nonprofit enterprises (CNEs) enjoy a significant competitive edge over taxpaying private firms. It does not, however, necessarily follow that lower costs will cause CNEs to set prices which undercut those charged by their private sector competitors. After all, CNEs could charge the same prices as private firms and enjoy a larger profit margin.

Economic theory indicates that, if CNEs sought to maximize profits, they would price their goods and services competitively, even though they have a cost advantage. Nevertheless, there is ample evidence that CNEs engage in a form of "predatory pricing," i.e., they charge lower prices than their private counterparts. Often, the promotional materials developed by CNEs stress that their prices are "breakeven" or "at cost." If this type of pricing behavior was being conducted by a foreign competitor it would be called "dumping." In some cases, goods and services are provided to customers at a purely nominal price or even zero price. There are numerous examples of this pricing behavior by CNEs and a number of reasons can be offered to explain why it occurs.

There is ample evidence that commercial nonprofits set their prices at breakdown levels or at cost. If this type of pricing was being conducted by a foreign competitor it would be called "dumping."

In Fairfax County, Virginia, a suburb of Washington, D.C., the county library system offers patrons videotapes at no charge. Private companies which rent the same tapes to customers require payment of membership fees as well as daily rental charges. Thus, the library, supported entirely by tax revenues, competes directly with private firms and actively pursues a predatory pricing policy—no commercial entity can routinely provide services at zero price. This practice is widespread, for "many public libraries loan films at little or no charge. College and university film rental libraries rent 16mm film (and occasionally video tapes) at costs lower than commercial distributors."[7]

In addition, in the Mount Vernon district, the Fairfax County government constructed an ice skating rink using tax-exempt bonds to finance the project. This facility charges lower entrance fees than a private ice rink which existed for a number of years prior to the completion of the public rink.

panies using this program through the productivity division is for the materials used?"[14]

In 1980, Apple SWAP (an acronym for Apple Software With A Purpose) was established as an independent, nonprofit, national clearinghouse for educational programs written for the Apple microcomputer. "To access the library of Apple programs, participants must initially provide the library with a blank Apple disk, a disk of programs, and one dollar in return for another disk of programs. After that, participants need only provide a disk of their programs and one dollar for each disk of programs they wish to receive."[15] No private firm could possibly compete with a nonprofit such as this which charges purely nominal fees to users.

CNEs which base their prices on production costs, a practice which the above examples show to be common, have a significant advantage over their for-profit competitors. Taxes are an important cost of doing business, as are postal charges, so that nonprofit status confers a distinct advantage in the marketplace over competing commercial firms. In addition, private firms must recover all the costs of production and sales before earning a profit, but for many CNEs, production costs are also heavily subsidized. Equipment may have been obtained through tax revenues; for CNEs that are agencies of state or local governments, such as colleges and universities or schools, much of the "overhead" may also be paid by the taxpayer.

Because nonprofit enterprises receive subsidies from the taxpayer, it is "good politics" to offer goods and services at below market prices.

Audiovisual centers at institutions of higher learning may have space for offices and production activities, telephone service, heat and utilities, and other services provided at no explicit charge. If this is the case, even cost-recovery prices do not have to reflect these expenses. Stated simply, virtually any CNE can set prices at a level that private competitors would regard as predatory and still be able to cover costs simply because the CNE's costs are so heavily subsidized.

Several reasons may be offered to explain why CNEs practice predatory pricing in the market for audiovisual instructional materials and for microcomputer software programs. First, political considerations can induce CNEs, which receive subsidies directly from the taxpayer, to offer goods and services at prices below market or, indeed, at zero price to benefit politically powerful groups of consumers (who are often of above-average incomes).

Libraries may offer videos and films at nominal or no charge and publicly-financed skating rinks may charge low admission fees as a way of transferring income to constituents who benefit and who are likely to provide active political support for such programs.

audiovisual materials before they are purchased or rented. In contrast, the sales catalogs for CNEs typically give the user only two options: rental or purchase. Consider the policies stated in Cornell University's *Audio-Visual Resource Catalog:*

> *Preview for Purchase.* Preview prints are available on the same basis as rental films listed in this catalog. If the previewed film is purchased within sixty (60) days of the preview date, any paid rental fee will be deducted from the film purchase price. Return of films is the user's responsibility.[19]

The citation above pertains only to films; with regard to slide sets, the restrictions are even more stringent: "Requests for *previewing purchase slide sets* cannot be honored. . . ."[20] Rental is not even an option with Cornell's audio tapes: "Because of the high costs of handling orders relative to the purchase price, it is impractical to rent audio tapes:"[21] Thus, CNEs often limit the opportunities for prospective customers to evaluate the quality of the materials to be rented or purchased; costs are imposed on customers who do screen materials in advance.

The consumer who recognizes inferior quality may still purchase the CNE's product because the price difference is disproportionately larger than the difference in quality. The audiovisual material produced by the CNE may have imperfections and flaws which make it mediocre relative to that produced by a private, profit-seeking firm, but if there is a substantial price differential, there is likely a strong incentive to purchase the inferior good from a CNE. The customers who buy and rent audiovisual materials for instructional purposes are frequently educators who may have a natural bias toward the product of an educational institution. Even when the consumer is not an educator, there is a bias toward nonprofit organizations in general. Along with the special legal privileges which CNEs enjoy, nonprofits in this country have acquired a "pro bono publico" [for the good of the public] image. Marc Lane, author of the *Legal Handbook for Nonprofit Organizations,* asserts that "even if we put aside possible tax advantages, the nonprofit entity has an unfair advantage [relative to private firms] owing to the public image of nonprofit status:"[22]

Thus, a third reason that CNEs charge lower prices than their private sector competitors is this "pro bono publico" image that CNEs enjoy. By definition, nonprofits do not operate to earn a profit and, because of their well-known tax and cost advantages granted by legislative fiat, any CNEs that charged the same prices as a private firm for similar goods and services would appear to be operating to make a profit. Thus, one means of affirming to the public that CNEs are, in fact, nonprofit organizations is to charge prices that are lower than those charged by private, profit-seeking firms. Lower prices, however, do not necessarily mean that the CNE's profits are nonexistent; only that they are below the level that would be earned if, other things equal, prices were closer to those charged by private firms. Predatory pricing offers a means for the CNE to share some of the benefits derived from its special privileges with its customers for public relations purposes.

[i.e., the "thin market" films] are not even listed in this catalog. As the catalog states, "Many films for which there is little demand or where replacement materials are not available are retired to the reference library. The reference library currently consists of more than 2,200 titles which are available for use by writing the Audio-Visual Center."[25]

If nonprofit organizations only produced and distributed audiovisual instructional materials of an esoteric and specialized nature, drawing on their special expertise and resources, there would be no complaints of unfair competition from private sector firms. The fact that the private sector is concerned about competition from nonprofits is direct evidence that nonprofits compete with them for customers and sales. There is a great deal of duplication of products and services in the audiovisual industry and in microcomputer software.

If nonprofit organizations only produced and distributed specialized audiovisual instructional materials, there would be no complaints of unfair competition from private sector firms.

Thus, the notion that nonprofits entered the market for audiovisual educational materials and computer software to provide services that the private sector avoided because there was insufficient demand is questionable. There are cases of highly specialized and esoteric material where this rationale might be applicable, but these are the exception and by no means the rule. Commercial enterprises would not be concerned about nonprofit entry into market vacuums which commercial firms did not wish to fill.

A more likely interpretation of events is that some nonprofits started out to satisfy a perceived need that was not being met by profit-seeking organizations and found it worthwhile, once in the market, to expand their offerings in competition with products and services already being provided by the private sector. All that is required for this scenario to be plausible is that economies of scale exist—in other words, unit costs decline as output rises. There are ample reasons to believe that economies of scale are present in this industry. For example, printing costs do not double if the number of entries in product catalogs double, nor do promotional postage costs. Moreover, in a very thin market, the demand may be so limited that the costs associated with serving the market are prohibitive, even for a subsidized nonprofit. To realize the benefits of economies of scale and thereby lower costs, nonprofits that may begin operations to serve a thin market exclusively can find it necessary to expand their product line and services to break even or to attain a scale of operation that is economically viable.

> In 1978, MECC established a precedent-setting statewide contract that allowed schools and colleges to purchase Apple II computers at a reduced price. This contract was the driving force behind Minnesota's plunge into instructional microcomputing. In three year's time, nearly 3,000 Apple II systems have been purchased on that contract.
>
> In addition to training educators in how to use the Apple II, MECC set about to develop a collection of nearly 50 diskettes for the classroom.
>
> Over a dozen of these diskettes offer elementary school applications. Others include simulations in science and social studies, model accounting and payroll packages for business education, a complete set of drills for music theory fundamentals, and the rules for basketball.[28]

Thus, microcomputer technology changed MECC from an organization that primarily provided centralized computer services to a developer and marketer of educational software for the new generation of equipment and to a cooperative purchaser of equipment. Through its mandate from the state, MECC was well established as the preeminent source of computer services for the state's hundreds of school districts and its far-flung college and university system. By centralizing purchasing and offering large-scale procurements, it was able to acquire microcomputers and peripheral equipment directly from manufacturers at prices much lower than could be negotiated by small independent retailers who were effectively excluded from the educational hardware and software markets in Minnesota.

Once the programs for instructional use had been developed, a "natural" step was to offer these to other educational establishments outside the state of Minnesota. The cost of development could then be spread over a great many purchasers, for even though the Minnesota market consisted of more than 400 school districts, it represented only a small portion of the total market for educational software throughout the U.S. and, indeed, the world. Moreover, the rapid expansion of the use of "personal computers" used in the home presented a lucrative market for software, as did the growing demand for software for administrative use in educational institutions. In its report to the Minnesota legislature, MECC claimed to have an "entrepreneurial spirit" and had already taken steps to provide products and services for all these markets.[29] MECC was committed to becoming a major force in the computer software industry for education throughout the U.S.

MECC not only expanded the scope of its products to reach the home computer user and to fill a variety of needs of educational administrators, but, beginning in 1979, it also offered annual institutional membership to nonprofit educational institutions or agencies outside the state of Minnesota: "The number of members served has grown substantially. During the 1984-85 service year, 153 agencies serving a clientele of over 4,300 school districts have taken advantage of this unique opportunity. Memberships are held by at least one agency in 49 states, most Canadian provinces, Australia, Bermuda, and English-speaking schools throughout the world."[30]

Each institutional member pays an initial membership fee and an

layed its virtual monopoly on the educational software and hardware markets in that state into a dominant position in the national market for educational software. MECC's "entrepreneurial spirit" was aided by the special privileges granted to nonprofits by government—there is no indication on the income statement that any taxes were paid to any level of government. Indeed, the last thing MECC officials wish to do is to pay taxes, for the Legislative Report specifically states that "MECC needs the ability to create subsidiaries in order to report revenues properly and *properly save federal tax payments* [emphasis added]."[38] Evidently, MECC officials were not only aware of the commercial nature of their activities, but were also concerned about designing ways to protect the organization's revenues from taxation. Further evidence that MECC competed directly with private firms is provided in the Legislative Report by the following statements: "The MECC Board is presently limited in its management of compensation policies. This limitation should be removed in order to *allow MECC to compete in the very competitive markets of commercial software production and distribution* [emphasis added]."[39] Apparently, as a subdivision of the state government, civil service regulations placed restrictions on compensation policy —restrictions which made it difficult for MECC to compete as effectively as it wished with private firms that were not subject to such limitations.

Minnesota's Educational Computing Corporation, though formally an extension of the government of the state of Minnesota, has evolved into a commercial entity, parlaying its virtual monopoly on educational software and hardware in that state into a dominant position in the national market for educational software.

Like other CNEs which compete unfairly with private firms in the market for educational software and audiovisual learning aids, MECC implicitly claimed that private firms were not responsive to the needs of Minnesota schools, i.e., the market was "too thin."[40]

It is not surprising that there were few commercial products available, or that they were expensive. No private firm could possibly compete in the educational software market with MECC, which enjoyed the special privileges of a CNE — direct taxpayer subsidies, a favorable "image," and a captive market in the state of Minnesota. By aggressively selling its products and services, MECC is a dominant participant in the educational software market.

Private firms are at a distinct disadvantage in competing with MECC since there is always the concern that MECC will produce a competing good

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2. Thomas W. Hope, "In the Matter of Money," *Instructional Innovator,* May 1981, p. 11.

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22. Marc Lane, *Legal Handbook for Nonprofit Organizations* (New York: AMACOM, 1980), p. 273.

23. *MIT Video Short Courses for Continuing Education* (Cambridge, Mass.: Massachusetts Institute of Technology, Center for Advanced Engineering, 1980), p. 52.

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26. Minnesota Educational Computing Corporation, "MECC Legislative Report," (St. Paul, Minn.: MECC, March 1, 1985), p. 1.

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31. Ibid.

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33. Ibid., p. 2.

34. Ibid., p. 14.

35. Ibid., p. 13.

36. Ibid.

37. Ibid., p. 6.

38. Ibid., p. 1.

39. Ibid.

40. Ibid., p. 5.

and sell it to its affiliated members at nominal cost. Virtually all of the costs of developing new computer software are the fixed costs of writing and testing it. Once the program has been written, the marketing and distribution costs become significant — the cost of duplication is purely nominal. For the producer to make a profit, the "up front" costs must be recovered and an efficient distribution and marketing system must be in place. If only a small number of copies of the program are sold, the high fixed costs must be spread over a small number of units, so that the price of each individual unit must be high. Alternatively, if a large number is sold, the price can be much lower. Again, economies of scale play an important role in the operation of the market and MECC's captive customer base of Minnesota school districts provides an important edge over any private competitor.

Conclusion

Private firms engaged in the production and distribution of audiovisual materials and computer software for instructional purposes are subject to aggressive, intense, and unfair competition on a wide scale from a host of commercial nonprofit enterprises and from government itself at every level. The economic implications of this unfair competition may be stated simply: Existing taxpaying firms are threatened and new firms are discouraged from entering this industry. In view of the massive advantages enjoyed by commercial nonprofit enterprises and public enterprises relative to their private counterparts, it is reasonable to predict that the profit-seeking segment of this industry will continue to decline unless public policy is changed to alter the terms of competition.

annual renewal fee thereafter; the amount paid depends on the number of schools in the district. "Member school districts receive a variety of services and products, including a select group of MECC instructional products for the Apple II series of computers, copying rights to most MECC Apple products [at a nominal charge per disk copied], availability of copying rights to MECC IBM instructional products, complimentary registration to MECC's national conference, optional training services and discounted purchasing rights on all MECC products, including products for Commodore, Tandy, and Atari computers. These services also include telephone consultation and tailored in-service training sessions at member sites."[31] This membership arrangement has been very lucrative for MECC — institutional membership produced nearly $2.3 million in 1984 or about 34 percent of total revenues.[32]

To make its products more attractive to users outside Minnesota, MECC expanded the range of its services as it expanded geographically. Training sessions were offered to users on a consulting basis at their site and MECC held workshops at national conferences in conjunction with marketing efforts: "In conjunction with efforts to market software across the country, MECC has provided training in other states on a consulting basis. Many of these sessions have been sponsored by MECC institutional members. The premier training event of the year was the MECC '84 national conference. . . . Over 2,000 educators, 40 percent of whom came from outside Minnesota, came to take advantage of the 100 presentations and 16 full workshops that were offered."[33] In the 1984-85 accounting year, MECC made 480 visitations to school districts, and held 60 short workshops, 200 extended workshops and classes, and 6 conferences.[34] These also generated significant revenues for MECC—the annual conference brought in almost $200,000, while instructional and administrative training and support produced about $225,000; hardware installation and repair services contributed $529,000 to MECC's income.[35]

At the same time that MECC was being supported by its institutional members, the state-owned corporation was receiving revenues from a variety of governmental sources, such as the state university system, the Minnesota Department of Education, the Bureau of Indian Affairs, as well as direct appropriations to MECC from the Minnesota legislature.[36] MECC's officers viewed attracting taxpayers' support as an essential task of its "image" and its marketing strategy.[37] If the Minnesota legislature makes direct appropriations to MECC (rather than have MECC's funds flow through the state university system or the Board of Education's appropriation), a clear signal will be given to all and sundry (especially MECC's potential competitors) that MECC has the government's imprimatur as the principal (if not sole) supplier of software and hardware to educational institutions in Minnesota. The unstated, but equally obvious, intent is to discourage competitors.

Even though MECC is formally an extension of the government of the state of Minnesota, it quickly evolved into a commercial entity which par-

A Case Study — Minnesota Educational Computing Corporation. In 1973 the Minnesota legislature established the Minnesota Educational Computing Consortium (MECC) to provide educational computing facilities and services for the state. The consortium had four members: the State Department of Education (437 school districts), the Minnesota Community College System (18 campuses), the Minnesota State University System (7 campuses), and the University of Minnesota. In 1984, the legislature changed MECC into a public corporation directed by a nine member Board of Directors appointed by the governor. According to MECC's 1985 Legislative Report,

> MECC is nationally and internationally recognized as a leader among educational computing support groups; is among the largest publishers of educational computer courseware; and is well-versed in all aspects of educational courseware design and development, including database management and information retrieval systems. Other services offered by MECC include training of educators, development and implementation of computer-based management information systems, and support for the acquisition and operation of microcomputers.[26]

When MECC was founded, computers were vastly different from the relatively inexpensive desktop versions that are now common in homes and offices. In the early 1970s, computers were very expensive (many cost millions of dollars), large in size, and difficult to maintain and service. Such equipment was beyond the capabilities of small colleges and universities and most school districts to own and operate. Economies of scale are readily apparent in such situations. A central computer can be installed with access to distant users through telecommunications equipment. In response to perceived computing needs for educational purposes, MECC established the MECC Timeshare System, a large Control Data computer accessible to 400 users simultaneously through a telecommunications network that reached 1,200 timeshare terminals located across the state. More than 300 point-to-point telephone lines and an equal number of "dial in" lines provided the connections to every public college campus in the state and to a majority of Minnesota's school districts. Users were billed only for the equipment at their site and for the computer time used.[27] MECC was responsible for the central computer and for developing software for instructional and administrative purposes. This timesharing arrangement provided powerful computational services at low cost to users and, at the same time, prevented the proliferation of incompatible equipment.

With the introduction of smaller, relatively inexpensive, and more reliable microcomputers in the late 1970s, the Timeshare System was maintained for applications requiring large-scale computational abilities, such as statistical packages, a database management system, and an electronic mail system. MECC's approach changed with technology as the microcomputer became popular:

Finally, the manager of a CNE has no strong incentive to maximize profits because the manager's income is not directly influenced by profitability. In educational institutions, especially at state schools, salary levels are not tied to profits, but are set by administrators or by civil service regulations. Therefore, even if the CNE could earn a greater profit by raising prices to competitive levels, the manager cannot benefit personally from doing so. Moreover, if CNEs were to charge the same prices as the private firms with which they compete, employees of CNEs would have to be much more aggressive in marketing their products and services because they would no longer have the advantage of below-market prices to induce customers to patronize their organization. A relaxed pace of work is an important component of the perquisites enjoyed by employees in the public sector and in other organizations which are not-for-profit oriented. Predatory pricing may be regarded as a means of obtaining this perquisite.

The Rationale for Nonprofit Competition

It is clear that the goods and services provided by the audiovisual industry or the instructional software industry for microcomputers cannot reasonably be regarded as public goods. Films, slide sets, videos, and computer programs have the characteristics of private goods and the fact that private firms are actively engaged in the production, promotion, and distribution of these products provides confirmation of their status as private goods: Profit-seeking firms would not provide public goods without taxpayer subsidies.

The basic rationale for nonprofit involvement in these industries is the "thin market" argument which, in effect, says that "There are too few customers for this product to entice a for-profit company to provide it." Without the nonprofit product, there would be no product.

The thin market argument might well be applicable in cases where highly technical materials are the subject of audiovisuals. These products tend to reflect the specialized research equipment and professional staff that are available at the producing educational institution.[23]

Not all of the films, however, are aimed at a limited audience; there are also films on basic calculus, basic probability, principles of economics, and energy conservation which would have a much broader appeal. The thin market argument would have to be stretched considerably to be applicable to all the audiovisuals that are offered.

The catalog of the Audio-Visual Center at Indiana University lists 6,388 titles of motion pictures in active use.[24] The films are classified under hundreds of subject headings ranging from "Ability—Testing" to "Zoos," and materials are available for every age group and educational level.

The thin market rationale does not apply to these films, all of which are in high demand, because audiovisual materials which have a low demand

A second reason that CNEs may practice predatory pricing relates to the quality of goods and services offered. In many cases the product produced by the CNE is of lower quality than that provided by the private sector. At educational institutions, for example, teachers or professors may donate text- or script-writing time even though they are not professionals in the field; an administrator with no credentials in broadcasting may be selected to record or narrate the material; and students with no previous experience may be recruited for acting, artwork, filming, and other production services. Experience as a teacher or professor in the classroom does not necessarily provide the skills required to develop high quality educational resources. This point is illustrated by the production of educational software for microcomputers. Apple SWAP notes that of the more than 8,000 programs submitted in 1980-81 by educators from half the states and seven foreign countries, only 15 percent were deemed useful and accepted into its library for public access.[16] Similarly, Dr. Gerald Gleason, a professor of educational psychology at the University of Wisconsin, Milwaukee writes in a critique of microcomputers in education that

> [A] major source of programs [is] educators. The teachers probably have not had any formal training or experience in programming techniques, and this is likely to be reflected in their products. Again, some of these programs may be useful and effective, but most will not meet the quality standards we should expect. Preparing a good CAI [Computer-Assisted Instruction] program . . . is an extremely time-consuming and expensive process, well beyond the capability and resources of individuals and even small groups of teachers. One only has to examine some of the programs offered for sale to realize that there is far more to CAI programming than learning to operate a microcomputer.[17]

Educational experience alone is not sufficient to ensure quality, nor is nonprofit publishing experience. In a review of "Our Political System," a National Geographic filmstrip/cassette package for grades 5-12, Dwain Thomas, supervisor of the Instructional Services Department at Lake Park High School in Rosell, Illinois, writes that "The National Geographic Society typically is synonymous with quality photography. This new kit on our political system does contain striking visuals, but it lacks much in terms of instructional objectives and content substance. . . . Not recommended for purchase."[18]

In contrast, private, profit-seeking firms have a strong incentive to provide high quality materials; the commercial marketplace has little tolerance for shoddy merchandise as competition will drive poor products from the market.

If competition operates in the marketplace to drive firms that produce poor quality products out of business, why do the same forces not operate in the same way with regard to CNEs? In part, this question may be answered by noting that CNEs operate differently from private firms which, as standard practice, usually give the purchaser the opportunity to preview

Unfair pricing is also illustrated by the activities of WGVC-TV, a public television station licensed to Michigan's Grand Valley State Colleges. In anticipation of reductions in taxpayer funding for the station's operations, WGVC began to solicit video production business by direct mail. All of the equipment owned by WGVC for commercial use, including a mobile unit, minicams, and studio facilities, was obtained either in whole or in part with state or federal funds.[8] In fact, in 1981, the station manager informed *West Michigan* magazine that WGVC had become one of the best-equipped studios in the region for television and field production.[9] This equipment was purchased for noncommercial purposes, that is, for student training and the production of local programs. In addition, 36 percent of WGVC's annual operating budget is tax-supported (divided about equally between state and federal funding).[10] Thus, the private, taxpaying firms in western Michigan are, in effect, subsidizing this competitor which charges only one-third to one-half the rates that commercial companies charge for the same services.

There are abundant examples of CNEs that price their services only to recover costs or part of the costs. The Occupational Curriculum Laboratory at East Texas University is one of "four centers within the Texas Curriculum Network funded by the Texas Education Agency... [which] is currently developing and disseminating competency-based materials for both secondary and postsecondary programs."[11] The OCL's product catalog notes that "Complimentary copies are not available because the OCL operates on a cost recovery basis."[12]

Similarly, the National Dissemination and Assessment Center, Los Angeles (NDAC-LA), located at California State University, Los Angeles, is "funded by the Office of Bilingual Education to provide support services to all other bilingual programs at state, post-secondary and school district levels." A promotional brochure issued by NDAC-LA indicates "a growing inventory of texts, booklets, visuals . . . which may interest and help you." A cover letter accompanying the brochure indicates that all the materials are "available at cost plus mail charges." In addition, the brochure indicates that "The NDAC-LA's central function is to receive, find, edit, and print materials judged to fill the needs of bilingual programs. The printing and reproduction capabilities of the Center cover all possibilities, the only limitation being cost."[13]

The Oklahoma State Department of Vocational and Technical Education established a "productivity division that links vocational education with a pressing need of American business and industry—developing a work force that understands its role in productivity." Two state employees "travel throughout the state to provide orientation, training, and other services in a variety of settings. They have at their fingertips an array of materials and approaches to meet the individual training needs of employers—seminars, workshops, quality circles, case studies, analytical problem solving, lectures, films, videotapes and slide-tape programs. . . . The only cost to com-

IMC involvement in the marketplace was limited by an explicit restriction stating that only educational materials developed "in house" by MSU faculty could be promoted by IMC; materials from other sources are not accepted. The operation has been, at least from the perspective of IMC, a major success:

> Since its beginnings, the marketing division's sales have shown a steady increase . . . instructional materials have been purchased nationally and internationally. . . [which] has resulted in a growing list of clients.[4]

The economic climate for education at all levels changed dramatically in the early 1980s as threats of budget cuts emanated from the Reagan administration and state and local budgets declined during the most severe recession since the Great Depression of the 1930s. Education officials and administrators sought alternative sources of revenue to offset real or perceived budget cuts and the successful commercial ventures established earlier by educational institutions, such as IMC at Michigan State, provided an excellent prototype. Entrepreneurial activity was pursued with a vengeance, as evidenced by the program developed by the Montclair, New Jersey school district which was faced with a reduction of $600,000 in federal funds for the 1981-1982 school year. The school board of Montclair approved the following commercial activities:

> Expanding the school district's data-processing center and paying someone to sell data services to 31 surrounding school districts.
>
> Publishing books and pamphlets on education topics written by the district's administrators and teachers, printed in its shop and promoted by three of its public-relations people.
>
> Bidding on federal government contracts for such things as military-educational materials, sex-education pamphlets for parents and running desegregation workshops nationwide.
>
> Establishing an education center for the district's emotionally disturbed students and taking in tuition-paying students from adjacent districts.
>
> Operating a public restaurant as a vocational training program at a planetarium built with a foundation grant.[5]

In response to these ambitious initiatives, the State Commissioner of Education for the State of New Jersey endorsed these planned forays into the private sector and touted the Montclair school district as a "lighthouse in education."[6]

These two examples illustrate that nonprofit competition with private firms may have started for a variety of reasons, ranging from serendipity to design. The result, however, is the same: For-profit firms suffer as nonprofits use their tax-exempt status and other special privileges to engage in unfair competition.

protected from litigation. Even when it is possible to bring suit against a nonprofit, the process is often prohibitively expensive for the plaintiff. The decisive advantages enjoyed by commercial nonprofit enterprises enable them to charge much lower prices and user fees than their taxpaying, for-profit competitors.

Small business firms make up a critical component of the national economy and, in recent years, have been responsible for most of the new jobs created. Thus the crowding out of small businesses by the commercial nonprofit sector can have serious economic implications. This report examines this unfair competition in the computer software and audio visual services industries to illustrate its economic effects.

Unfair Competition in the Audiovisual Industry

The potential of Thomas Edison's "moving pictures" as an educational device was recognized almost as quickly as its potential for public entertainment. Although it would be difficult to identify the first film developed primarily for instructional purposes, an industry devoted to the production, promotion, and distribution of audiovisual materials has been in existence in the U.S. for at least half a century. The industry's major customers are schools, libraries, colleges and universities, businesses, and governmental agencies which use the products to educate, communicate, and train. The products of and the processes used by firms in this industry have changed as technological innovations, such as television, videotape, and videocassette recorders, have appeared. Little is known about the structure and composition of this industry, except that it consists of a large number of geographically dispersed small companies. It has been estimated that 95 percent of firms in the audiovisual (AV) industry had annual revenues under $5 million in 1981 and total sales for the entire industry in that year were between $300 and $400 million.[1] In essence, the typical firm is a "mom and pop" operation.

The characterization of the audiovisual industry as highly fragmented and widely dispersed is supported by the descriptive overview given by an industry consultant:

> Of more than a million persons who earn their living using AV media or supplying the products or services, a fifth are suppliers manufacturing, producing, or selling products and services. In the AV industry there are more than 15,000 companies and institutions — the great majority private businesses. Nearly 1,000 are institutions, such as libraries and university film libraries serving education and the public. Another 2,000 sources of educational materials are not in the AV business per se.
>
> Some 4,000 producers and services that make media software comprise the largest category in the AV industry. Many of these companies are very small, even one-person operations. Probably half produce educational media that are sold either through education distributors direct to schools or through AV dealers.[2]

Contents

This booklet is one in a series designed to enhance the understanding of the private enterprise system and the key forces affecting it. The series provides a forum for considering vital current issues in public policy and for communicating these views to a wide audience in the business, government, and academic communities. Publications include papers and speeches, conference proceedings, and other research results of the Center for the Study of American Business.