Preface

This volume addresses the need to revisit the very economic theories that in the past two decades have contributed so much to the development of a concentrated research agenda on nonprofit organizations. Long neglected as a topic of theorizing and empirical investigation by mainstream economics in particular, these initial theories of nonprofit organizations, introduced by Burton Weisbrod (see Chapter 3 by Kingma and Chapter 4 by Slivinsky) and Henry Hansmann (see Chapter 5 by Ortmann and Schlesinger and Chapter 6 by Hansmann) and others in the late 1970s and early 1980s, continue to shape theoretical and conceptual efforts. Importantly, their influence extends beyond economics and informs sociological and political science approaches to the set of organizations and institutions located between the market firm and the state agency as well (see Chapter 10 by Wolpert, Chapter 11 by Salamon, and Chapter 12 by Wolch; also Anheier & Ben-Ner, 1997; DiMaggio & Anheier, 1990).

While the theoretical map of nonprofit research has expanded beyond these early attempts and now includes several other major theories such as stakeholder approaches (Chapter 1 by Ben-Ner and Gui, and Chapter 7 by Krashinsky), supply-side or entrepreneurial theories (Chapter 8 by Badelt and Chapter 9 by Young), institutional theories (Chapter 17 by DiMaggio), and comparative approaches (Chapter 15 by Anheier; see also Salamon & Anheier, 1998), we nonetheless suggest that it is time to take stock and reexamine some of the very basics from which these economic theories operate. This is the main purpose of the book.

Three topics emerge as central issues that together account for a need to reevaluate economic reasoning about nonprofit organizations: First, we feel that there is a strong need to assess available theories in the light of the empirical evidence that has become available in recent years; second, we see an equally strong need to take stock of the conceptual inventory of the terms used in constructing economic theories in the field; and third, we need to evaluate the extent to which microeconomic theories do in fact inform empirical research as well the extent to which this research contributes to theoretical advancements in economics as well as in other social sciences. We will briefly address each issue.

BROAD BODY OF EMPIRICAL EVIDENCE

Recent years have witnessed the accumulation of empirical work that puts theories at least partially to test. Such work provides evidence for key aspects in support of general theoretical reasoning as well as particular hypotheses, but also for propositions and underlying assumptions (see Chapter 16 by Steinberg). For example, Steinberg and Gray (1994) offer a summary of empirical studies as they relate Hansmann's trustworthiness thesis and arrive at a mixed verdict: "Hansmann's predictions are well supported in some nonprofit industries, doubtful in others" (1987, p. 13; see also Chapters 5 and 6). Similarly, Weisbrod (1998) tests differences in consumer preferences and organizational behavior between for-profit, public, and nonprofit service providers (see also Chapter 3 by Kingma and Chapter 4 by Slivinski). He finds that theoretical expectations fit religious nonprofit organizations far better than secular nonprofit organizations, which are closer to for-profit and public sector providers in terms of the variables examined. Thus, organizational form, at least to some degree, seems to matter in understanding organizational behavior; yet religion and other basic value orientations seem to matter even more.

There has been a considerable amount of empirical work on nonprofit organizations not only in the United States (Hodgkinson, Weitzman, Abrahams, Gutchfield, & Stevenson, 1996) but also in many other parts of the world (Salamon & Anheier, 1996; see Chapter 15 by Anheier). Cross-industry and cross-national comparisons are increasingly becoming available and we need to weigh their evidence against the theoretical expectations that flow from microeconomic models (see Chapter 13 by Galaskiewicz and Bielefeld, and Chapter 14 by Brody). Frequently, these works cannot be used to test microeconomic theories and hypotheses directly, yet they nonetheless can take on a very important role in helping specify the conditions when a particular theory might apply and when not.

What are the theoretical implications for existing theories of nonprofit organizations? Where do we find conclusive and where contradictory evidence in support of one theory or another? What questions were examined more successfully and by what theory? What new developments and revisions of theories does the empirical evidence suggest? Thus, this volume aims at assessing current economic thinking on nonprofit organizations by taking inventory of how well theoretical expectations match the empirical evidence that has been accumulated in recent years (see Chapter 16 by Steinberg).

THEORETICAL INNOVATIONS AND REFINEMENTS

The last decade of nonprofit sector research was not so much a decade of basic theoretical innovation; much work was achieved primarily between 1975 and 1985 when Henry Hansmann's trustworthiness thesis, Burton Weisbrod's public goods theorem, Estelle James's heterogeneity argument and other economic theories were first introduced to provide theoretical foundations to a newly emerging field (see Rose-Ackerman, 1996; Hansmann, 1987; DiMaggio & Anheier, 1990, and Anheier & Ben-Ner, 1997 for background reading). Rather than that, it was a period of theoretical refinements and elaborations.

While the notions of trust, information asymmetry, public goods, demand heterogeneity, and transaction costs continue to serve as the building blocks of economic theories in this field, recent work expanded on previous research and improved our understanding of the origins of nonprofit organizations. While these improvements have been useful for our understanding of nonprofit organizations, we feel that there is nonetheless a need to reconsider the conceptual inventory of microeconomic theories. Specifically, we need to revisit the notions of trust and trustworthiness as they relate to risk and risk absorption, the implications of the theoretical equivalence between religious and secular behavior in economic models, and the array of pricing and costing options for public, quasi-public, and private goods and services that come into focus when considering nonprofit over alternative ways of service provisions.

Thus the present volume addresses the question if, and to what event, the conceptual inventory of nonprofit sector research is adequate to the task at hand, and explores avenues that might lead to an improvement, if applicable, of the basic "building blocks" of theories.

THEORETICAL INERTIA

The third reason for this volume relates to the way in which existing nonprofit theories are treated by economists and noneconomists alike. The social sciences have a tendency to retain "old" theories as basic reference points even though the theories themselves may no longer be fully adequate for current research efforts. We are therefore sensitive to the possibility that economic theories may not inform empirical research to the extent needed for continued theoretical development. For example, there is a tendency to portray all nonprofit theories as rival when some are, in fact, meant to compliment each other. Perhaps the best example is the sharp distinction that is sometimes drawn between the trustworthiness argument and the median voter thesis in public goods approaches (see Chapter 16 by Steinberg).

Moreover, some researchers in the field, particularly from outside economics, may be unaware of the often significant improvements and refinements of the early nonprofit sector theories and may mistakenly interpret first formulations as state of the art. How helpful, we ask, have economic theories been for other social sciences? Perhaps researchers may even perceive a theoretical "map" of the field much different from the one in economics?

At the same time, however, economists themselves may be unaware of much important work that takes place in the other social sciences, and economic theories may well benefit from the insights offered by sociology, political science, law and history—insights that could well contain conceptual and empirical material useful for economic theory building. Here we point to institutional theories (Chapter 10 by Wolpert) and organizational analysis (see Chapter 13 by Galaskiewicz and Bielefeld), in particular, population ecology (Chapter 17 by DiMaggio).

Thus this volume, while primarily targeted at and for economists, keeps on eager eye on other social sciences to help improve the interdisciplinary flow of communication in an effort to reduce potential theoretical inertia that seems to have built up in the field in recent years.

PLAN OF THE BOOK

The origins of the book go back to 1995 when the editors organized a symposium on "Economic theories of nonprofit organizations" at Yale University. The symposium brought together many of the scholars whose papers on the subject on economic theories of the nonprofit organizations are now collected in this volume. Earlier versions of five of the papers included here appeared in abbreviated form in a special issue of *Voluntas* in 1998 (Volume 2, issue 2). These papers by Ortmann and Schlesinger, Kingma, Badelt and Steinberg have been revised and expanded for this book; only one paper from the 1998 *Voluntas* issue, that is, on stakeholder theories of the nonprofit sector appears in its original form. All other contributions were especially commissioned.

Economics and the social sciences advance through debate among scholars, by the posing of arguments and counter-arguments that examine theories against available evidence, question assumptions, or bring in different perspectives. This 'give and take' in theoretical advancement is the basic model that underlies this book. After two overview chapters by Ben-Ner and Gui, and Bacchiega and Carlo Borzaga that attempt a critical synopsis of the state-of-the-art, the book addresses each of the leading theories in more detail: the public goods theory, the trust-related theories, stakeholder theories, entrepreneurial theories, and partnership theories.

In each case, we have argument and counter-argument in the sense that a separate, stand-alone chapter follows the critical evaluation of the theory in terms of evidence, assumptions, and fruitfulness. This chapter typically relates to both the theory and the evaluation of it, and develops different arguments and arrives, in most cases, at different conclusions. We also invited chapters that bring in different perspectives, in particular, organizational theory and policy analysis to both complement and challenge economic reasoning in this field.

Taken together, we hope that the contributions to this volume will push the academic discussion forward, and offer students and experts alike a useful introduction to a field of study that, while still young, has been able to accumulate a rich empirical and conceptual knowledge base.

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Chapter 1

The Theory of Nonprofit Organizations Revisited

AVNER BEN-NER AND BENEDETTO GUI

INTRODUCTION

Much has been written during the last two decades about the theory of nonprofit organizations (NPOs). Researchers, policy makers, and practitioners in NPOs have repeatedly asked themselves variants of the following set of questions:

- What do NPOs do that for-profit firms (FPFs) and government agencies are not doing already?
- Do NPOs operate as efficiently as their for-profit counterparts?
- Do NPOs serve the same broad groups as government units do?
- Should NPOs receive special tax treatment?

Competing and complementary theories have evolved to answer these questions. As the chapters in this book suggest, the answers depend on the perspective that guides the developers of a particular theory. The answers, it turns out, are not entirely at odds with each other because the differences among theories have been narrowed over time and do not reflect any longer completely different views of how the world of organizations works, but rather

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more nuanced differences concerning the relative importance of contextual factors. For example, the asymmetric information and public goods perspectives, once viewed as alternative theories of the nonprofit sector, are considered today mostly as theories that help explain different parts of the nonprofit sector. Even differences among theories originating in different disciplines, such as economics and sociology, have been muted as a better cross-disciplinary understanding has evolved and as more research on NPOs has revealed a more complex nature, origins, and behavior than that which is predicted by just one discipline (see DiMaggio & Anheier, 1990).

In this chapter, we seek to provide an integrative theory of NPOs, focusing on the nature of products, markets, and social environments that are conducive to reliance on NPOs in various industries, economies, and societies and to varying degrees. Our intent is to show that there is a clear (but generally not very visible) thread that links NPOs that operate in different areas and contexts, and that theories that emphasize particular areas and contexts should, therefore, be similarly linked. This, of course, does not diminish the insights or value of extant theories, including those discussed elsewhere in this volume, in explaining in detail the reasons for the existence of the nonprofit sector (or of its segments), as well as the mode of operation of NPOs. In a sense, all this chapter does is to elaborate on these theories and point out linkages and commonalities among them.

The theory we elaborate here holds the key, we believe, to answering the questions posed above. It is, however, beyond the scope of this chapter to actually broach these questions directly, although the discussion provides clues as to how to approach these questions from the perspective of the theory presented here.

We proceed by first defining NPOs, then move on to characterizing the nature of products they tend to provide, the type of markets in which they tend to concentrate, and other variables that affect the desirability of NPOs to various types of stakeholders. We organize the discussion by focusing separately on demand-side and supply-side factors involved in the creation and existence of NPOs. Our focus is on the difference between nonprofit organizations and FPFs, disregarding government agencies.[1] We do so for two reasons. First, we approach the theory of NPOs from the perspective of market dominance, that is, we ask what happens in a market environment if certain conditions are not met. Government is one type of answer, nonprofit organizations another, and we concentrate on the latter. Second, much of what we have to say about operating NPOs is invariant to whether they emerged in response to market or government failure. Although we will stress differences between FPFs and NPOs, we are aware that several features that we will present as peculiar to NPOs are present to a certain extent also in real-life FPFs.

In the subsequent sections we analyze demand and supply of the not-for-profit organizational forms and discuss some environmental influences on the evolution of the nonprofit sector in the following section. The last section presents concluding remarks on the place of NPOs in an economy.

NONPROFIT ORGANIZATIONS, THEIR BENEFICIARIES AND DECISION-MAKERS

The principal characteristic that distinguishes NPOs from other private organizations is the presence of strict limits on the appropriation of the organization's surplus in the form of monetary gain by those who run and control it. Most often these limits take the form of a statutory prohibition to distribute any dividends or bonuses—the so-called "nondistribution constraint"—that is usually accompanied by supplementary constraints aimed at preventing "excessive" executive compensation and self-serving dealings.[2] Instead, NPOs are expected to benefit a category of "beneficiary stakeholders" by providing them the opportunity to transact on favorable terms with the organization itself in the purchase of some organizational output or the sale of some organizational input.

NPOs are sometimes classified into two categories according to the approximate locus of organizational control. NPOs controlled by their beneficiaries are termed "mutual." Beneficiaries usually delegate considerable decision-making power to appointed administrators and managers who are more autonomous (due to both law and practice) than their counterparts in FPFs. In contrast, NPOs controlled by administrators who are required by law to uphold the fiduciary duty of serving the interests of others are called "entrepreneurial." Whereas this dichotomous view of the nonprofit world does not fit our theory, the terms are useful and we will use them in relevant contexts.

The attributes of NPOs generate both strengths and weaknesses as compared to FPFs. The main weakness stems from the muted monetary incentives for individuals to devote entrepreneurial resources to starting and operating NPOs. Illicit practices aside, profit-motivated entrepreneurs would never choose such an unattractive organizational form through which to pursue their objectives. The nonprofit form of organization will be chosen if it has certain strengths that overcome its weaknesses, either thanks to certain demand-side advantages, or due to supply-side incentives other than profit.

Demand for the Nonprofit Form of Organization

Markets would allocate resources efficiently in a world characterized by:

1. full satisfaction of the conditions for perfect competition (i.e., flexible prices, many "small" agents on both sides, and perfect information concerning the characteristics of goods exchanged);

Chapter 2

The Economics of the Third Sector

Toward a More Comprehensive Approach[1]

ALBERTO BACCHIEGA AND CARLO BORZAGA

INTRODUCTION

Several studies (Ciriec, 2000; Salamon & Anheier, 1994) have documented the growth, during the 1980s and the 1990s in the number of nonprofit organizations, in their employment share, and in their revenue. In several countries the nonprofit sector outperformed both the public and the private for-profit sector.

Another important aspect of the recent evolution has been the shift of a growing number of old and new nonprofit organizations toward a more productive and entrepreneurial stance. This shift has assumed different patterns in different countries, depending on the role previously played by the sector, its size, and its relationships with the public sector (mainly with the public welfare system).

In the United States, where nonprofit organizations already had an established and recognized productive role, this shift has displayed "a pattern of growing commercialism" (Weisbrod, 1998a). Nonprofits are more actively market oriented and seek out additional revenue sources by, for example,

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charging user fees on mission-related output, establishing new ancillary activities, and forming joint ventures with for-profit companies.

In European countries, the nonprofit sector has traditionally been less developed and recognized, more dependent on public policies, and advocacy oriented. The recent shift has been more toward a stable, continuous, and to some extent autonomous production both of social services and of other goods and services with the aim to integrate disadvantaged people into work. These activities are often, albeit not always, financed out of public resources. However, many of the services provided, or the methods of their delivery, are innovative, especially when compared with existing provision, both public and traditional nonprofit.[2]

Many elements of this change in behavior by nonprofit organizations can be highlighted by comparative analysis, starting with one of the most important of them: the differentiation of legal, institutional, and organizational forms.

While the U.S. legal framework has not changed, and differentiation mainly concerns the goals and the degree of the distributional mission[3] of organizations with different ideological commitments and operating in different sectors, in Europe the process has been more complex and profound. Most of the recently established nonprofit organizations do not take the incorporation form of foundations, or of other nonproprietary forms mainly or solely characterized by the distribution constraint; they have instead been incorporated as either associations or cooperatives. Both of these are proprietary organizations, sometimes owned by volunteers, but often by consumers or workers, and the nonprofit distribution constraint is not always their main institutional characteristic.

Traditionally, cooperatives did not engage in the production of social and welfare services, and associations carried out advocacy functions rather than productive activities. The legal status of both institutional forms changed during the 1990s in many European countries so that they could provide social services. Several kinds of "social cooperatives" or "cooperatives for social or collective purposes" were created, and at the same time the productive nature of associations was strengthened.[4] The cooperatives and associations that have now emerged from this process are similar in many respects: Cooperatives are guided by more public and less mutual aims, and associations are more entrepreneurial and productive in their behavior. Compared with traditional nonprofits, these new organizations rely much more heavily on the broader representation of stakeholder interests and on participative and democratic management than they do on the traditional nondistribution constraint.

In the light of this differentiation within and among European countries, the simple dichotomy between organizations allowed to distribute profit and those that are not, so widely used in the economic literature, does not suffice to explain the existence, roles, and evolution of the nonprofit sector.

A more general theoretical approach is required to understand these new phenomena. This approach should be able to explain the following: the plurality of roles performed by third sector organizations (advocacy for a particular group of citizens or for certain rights; redistribution of resources among individuals, groups, or activities; stable and continuous production of social and collective services); shifts from one role to another, and especially the recent shift toward more productive and entrepreneurial behavior; and the coexistence of a variety of organizational and legal forms characterized by different goals and constraints.

In our view, this more general approach can be developed by adopting the institutional approach to the study of organizations, but by taking into account suggestions that have been hitherto undervalued, integrating them with non-standard hypotheses on economic agents' behavior. Full understanding of the third sector and of its recent evolution requires us first to abandon an approach that considers, at least in theory, nonprofit organizations as able to compete in every market, and the adoption instead of the more realistic assumption that they are best suited, mainly or solely, to the provision of personal and community care services.[5] Second, it requires a more general definition of third sector organizations, one sufficiently flexible to include all their various roles and the diverse institutional features that they assume in different countries. This definition must be based, not on just one simple constraint, but on a more open set of characteristics including declared organizational goals, and the consistency among goals, legal constraints, and proprietary structure. Third, it requires us to relax the hypothesis that the economic agents, which interact with third sector organizations are by definition self-interested and opportunistic, and to instead assume the hypothesis that agents may have heterogeneous and complex utility functions. In other words, we must shift the focus from the role of the nondistribution or other constraints to the importance of the agents and the behavior of organization owners.

Taking into account these three analytical steps, our suggestion is to define third sector organizations as "incentive structures" which use a variety of different incentive mixes to induce the groups of agents involved (donors, volunteers, but also workers and managers) to behave consistently with the organizational goal. This goal may vary according to the importance of the distributional mission and the specific market failure that the organization must deal with. The incentive structures of third sector organizations, however, are different from those that prevail not only in for-profit and public providers but also among nonprofit organizations with different goals, proprietary structures, and institutional forms.

The chapter is organized as follows. The next section shows the shortcomings of theories based on the nonprofit distribution constraint. The third section highlights the distinctive features of the markets in which third sector

Chapter 3

Public Good Theories of the Nonprofit Sector

Weisbrod Revisited

BRUCE R. KINGMA

INTRODUCTION

Burton A. Weisbrod's (1975) "Toward a theory of the voluntary nonprofit sector in a three-sector economy" is a cornerstone in the literature on the economics of nonprofit organizations. In the Weisbrod model nonprofit organizations satisfy a demand for public goods, which is left unfilled by government provision. The government satisfies the demand of the median voter and therefore provides a level of the public good less than some citizens'—with a level of demand greater than the median voter's—desire. This unfilled demand for the public good is satisfied by nonprofit organizations. These nonprofit organizations are financed by the donations of citizens who want to increase the output of the public good.

A testament to the strength of the Weisbrod theory of nonprofit organizations is its wide acceptance and recognition within the economics literature. The original paper, Weisbrod (1975), subsequent reprints (1986, 1990), and book (1979) have produced over 100 citations in economics journals according to the Social Science Citation Index. This paper examines how the original theory has been revised, extended, and tested in the economics literature.

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The public goods theory of nonprofit organizations is a natural extension of the theory of club goods (Buchanan, 1965), Coase Theorem (1960), and the theory of collective action (Olson, 1965). In each theory the classic public goods or externality problem is resolved by the collective action of the individuals affected. Buchanan shows that collective action through clubs can be used to provide for the public good and examines the optimality of club membership. The Coase Theorem shows that the problems of markets with externalities not achieving the economically efficient level of output can be resolved through side-payments between the parties affected by or producing the externalities; while the theory of collective action by governments, organizations, and families illustrates the benefits and costs associated with providing for the public good. Likewise, the public good theory of nonprofit organizations provides an economic rational for the formation of nonprofit organizations to provide for the public good.

Over the past 20 years the public good theory of nonprofit organizations has been revised and extended. Economic theories of altruism parallel and influence the public good theory of nonprofit organizations; while the public good theory has been adapted to include a variety of stakeholders and their demands for a variety of public and private goods from nonprofit organizations.

Donative nonprofits providing public goods depend on the altruism of contributors. Economic theories of altruism examine the impact of changes in government funding for public goods on the level of charitable contributions. The influence of government funding on donations depends on whether altruism is "pure" whereby donors receive benefit only from the increase in the production of a pure public good or whether altruism is modeled as "impure" whereby donors also receive private benefits from their gifts.

The classic public good model of nonprofit organizations considers the organization as producing a single public good in response to the demands of donors. This theory has produced a testable hypothesis that there will be more nonprofit organizations in more heterogeneous communities. Since Weisbrod's original paper, this model has been extended by allowing for the nonprofit organization to produce more than one output and allowing for nonprofit managers, donors, patrons, employees, and volunteers to have different preferences over the production of the public goods. In each case the nonprofit organization provides a public good, which is differentiated from the good provided by the government or a for-profit organization.

This paper also explores the commonalities between the public good theory and the trust theory of nonprofit organizations. The trust theory of nonprofit organizations is modeled by Hansmann (1980). The trust theory models nonprofit organizations as providing goods, which consumers cannot trust for-profit organizations to provide in sufficient quality or quantity because of the information asymmetries between the consumer and producers of the goods. These goods may include day care, education, or health care. Nonprofit organizations, because of their stated goal not to seek a profit-maximizing goal, are more trusted by consumers to provide these goods. Trust, or the production of information to provide consumers with knowledge of the quality of goods and services, can be modeled as a public good.

DONATIVE NONPROFITS AND ECONOMIC THEORIES OF ALTRUISM

The public good theory of nonprofit organizations principally describes donative nonprofit organizations. This theory provides a rational for donors to make contributions in order to support the public good output of a nonprofit organization. Economic theories of altruism model the behavior of donors and therefore the support of donative nonprofits.

It is not necessarily true that theories of altruism describe nonprofit organizations. Typically, economic theories of altruism model donors as receiving some benefit or utility from their donation, without formally modeling the supply of the public good. Altruism can occur in the family, to support government or for-profit organizations, or simple exchanges between neighbors. However, the public good theory of nonprofit organizations requires modeling the donative support of altruistic agents.

An excellent review of the economic literature on altruism can be found in Rose-Ackerman (1996). A review of the experimental evidence can be found in Ledyard (1995); while a survey of the literature on the empirical evidence on crowd-out (the relationship between the financial support for public goods from government sources and its influence on the level of donations received by nonprofit organizations) can be found in Steinberg (1991).

The Pure Public Good Theory

If nonprofit organizations provide for public goods through donative support, which otherwise would have been provided by the government, the question arises what happens when government provision of the good changes? If donative nonprofit organizations provide pure public goods an increase in government spending will "crowd-out" charitable contributions. The dollar-for-dollar crowd-out of charitable contributions by government spending in the pure public good model is shown in Warr (1982) and Roberts (1984). However, a more comprehensive treatment of this question in Bergstrom, Blume, and Varian (1986) reveals that crowd-out may not be dollar-for-dollar since many donors will simply stop giving in response to an increase in government funding. Since the donor's original contribution may be less than the increase in government funding (i.e., the donor is forced to a corner solution on his budget constraint), crowd-out may be less than dollar-for-dollar.