The Nonprofit Theory Revisited

An Overview over the Third Sector and Its Prevailing Approaches

May 2012, Rasmus Bøgh Holmen

MENON
Business Economics

Content

- Introduction
- Categorization of Organizations in the Business Sector
- The Nonprofit Landscape
- The Theory of Demand for Nonprofits
- The Theory of Supply for Nonprofits
- Nonprofit Incentive Structure
- Financing of Nonprofits
- Conclusion

Introduction: Background

- My name is Rasmus Bøgh Holmen. I am an economist from University of Oslo with exchange periods at the University of Essex and University of Copenhagen.
- In addition, he has taken business at Oslo University College, as well as supplementary courses within economics and natural sciences at University of Oslo.
- I am an analyst at Menon Business Economics with earlier work experience, inter alia as an financial accountant at the Det Norske Veritas, an journalist at the E24.no and a seminar leader at the University of Oslo.
- This presentation is based on my master thesis '*The Nonprofit Theory Revisited: The Advantages and Challenges for the Third Sector*' from February 2012.
- The thesis symbolized the end of 5-year integrated master degree within economics and econometric methods at the University of Oslo
- I would like to thank my supervisor, professor Kjell Arne Brekke for useful guidance, productive feedback, fruitful discussions – and moreover – a good collaboration during the writing of my thesis.

Introduction: Definitions

- There is no consensus on which nonprofit definition to use among different authors.
- In my thesis and in this presentation, I generally choose to apply a broader definition for nonprofits, emphasizing the whole third sector; namely **every organization outside the public sector that does not have profit maximization as the sole primer aim, excluding poorly governed forprofits.**
- By this definition, I neither exclude business foundations, cooperatives, mutuals nor non-government organizations.
- An alternative definition, developed by Hansmann (1980) and implemented in legislations in many Western countries, highlights **certain private organizations' inability to distribute profit** as the main feature of nonprofits**.**

Introduction: Motivation

- Why study nonprofits?
  - In microeconomic textbooks, the focus lies mainly on the forprofit sector and the household sector, and their interaction with the public sector. The third sector is neglected, if not as unimportant so at least as irrelevant for the core study in microeconomics (see for instance Cowell 2006, Mas-Colell et al. 1995 or Varian 1992).
  - Despite of little attention among economic researchers, the whole third sector compromise large portions of the Western economies. After a downturn in relation to the financial crisis, the third sector is now growing once again.

Introduction: Research Focus

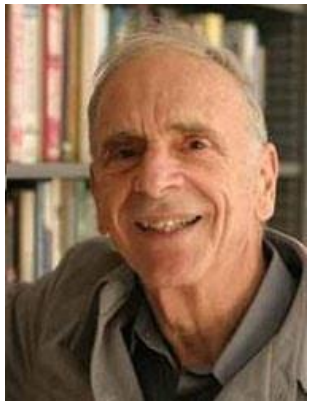
- The scoop of Nonprofit:
  - As we will see, the nonprofit sector compromises a wide range of different organizations.
  - In general, different nonprofits theories sheds lights on nonprofits in various business fields and a variety of institutional forms.
- My focus:
  - In my master thesis and in this presentation, I draw attention to nonprofits with core focus on the ones operating in the business sector.
  - Yet, all types of nonprofits are covered to some extent.

Introduction: Research Focus

- Main questions:
  - ‘What are the pros and cons of nonprofits, and in what ways do they differ from other organizations?’
- Probed furthers:
  - ‘What are the roles of the nonprofit sector, and why does it play these roles?’
  - ‘What do nonprofits do when they are not maximizing profit, and which other aims are relevant?’
  - ‘How does the interior incentive structure function when the organization has other aims than profits, and there are no owners to discipline the management?’

Introduction: Illustrating Quotes

My view is that nonprofits organizations are largely a way of solving informational problems. Managers of nonprofit organizations lack the incentive of profit that might otherwise tempt them to misrepresent their products or services **(Weisbrod 1988, page vii).**



Burton A. Weisbrod
Northwestern University

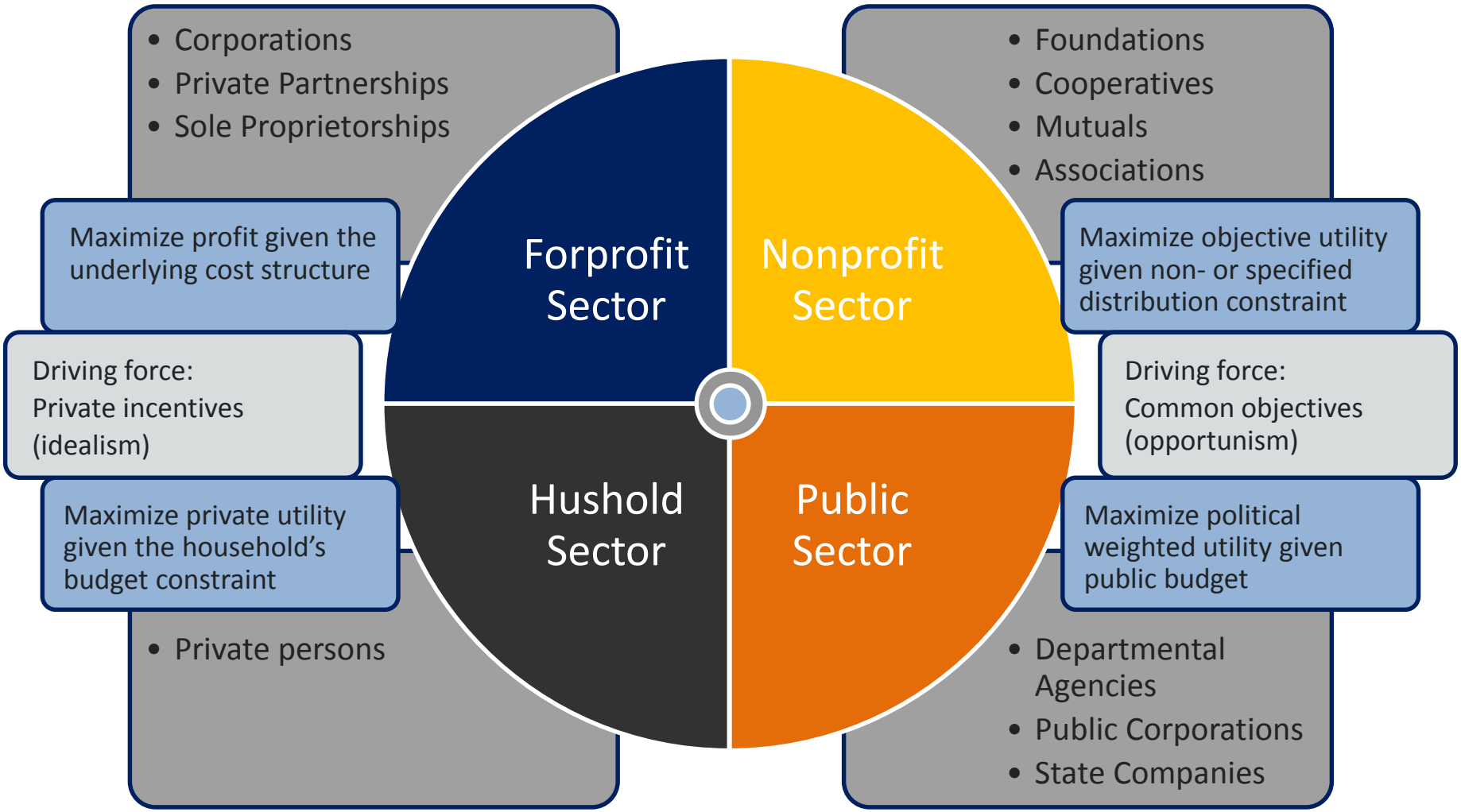
Henry B. Hansmann
Yale University

In spite of the limitation imposed upon them, nonprofits may succeed in distributing some of their net earnings through inflated salaries, various perquisites granted to employees and other forms of excess payments **(Hansmann 1980, page 844).**

Content

- Introduction
- Categorization of Organizations in the Business Sector
- The Nonprofit Landscape
- Theory of Demand for Nonprofits
- Theory of Supply for Nonprofits
- Nonprofit Incentive Structure
- Financing of Nonprofits
- Conclusion

Categorization of Organizations in the Business Sector



Categorization of Organizations in the Business Sector: Forprofits

- **Sole proprietorships:**
  - An sole proprietorships are legally inseparable from the owner, who must be a private person. Thus, they are characterized by strong personal control and have close relationship with the household sector.
  - Sole proprietorships have unlimited liability up to personal bankruptcy, which implies relative large risk for the owner and better solvency *ceteris paribus*. In addition, personal ownership typically have financial expansion rigidity, while financial austerity obviously is not a problem.
  - In most countries, sole proprietorships auditing face less stricter auditing duties than other firms.
  - In Norway these are known as *enkeltpersonforetak*. An enkeltpersonforetak may employ others.

Categorization of Organizations in the Business Sector: Forprofits

- **Private partnerships:**
  - Private partnerships are owned and controlled by two or more legal persons, that is private persons or legal entities.
  - More owners make these firms somewhat more financial flexible than sole proprietorships, but they are still characterized by financial rigidity. The degree of solvency will *ceteris paribus* depend positively on the degree of liability.
  - Theoretical subclasses: General partnerships (i.e. everyone has unlimited liability), limited liability partnerships (i.e. everyone has limited liability) and limited partnerships (i.e. some partners have unlimited liability and others limited liability).
  - Norwegian subclasses: *Ansvarlig selskap (ANS)* (i.e. everyone has unlimited liability), *ansvarlig selskap med delt ansvar (DA)* (i.e. everyone has unlimited liability for a given portion) and kommandist selskap (the owners are grouped into the *komplementars* with unlimited liability and the *kommandists* who hold unlimited liability).

Categorization of Organizations in the Business Sector: Forprofits

- **Forprofit corporations:**
  - A corporation is owned by one or several investors through transferable shares and constitutes a separate legal personality.
  - The operations are delegated to a management appointed by the owners through a board of directors.
  - The owners have limited liability in case of bankruptcy, but their claims will also be the last to be met.
  - Corporations owned by forprofits or individuals are occasionally referred to as a 'forprofit corporations', to distinguish them from public- and nonprofit-owned corporations.
  - Corporations could be divided into public (listed) and close (unlisted) corporations.
  - Public corporations are chiefly large, have strict auditory requirements, and their shares can easily be traded through a stock exchange, implying large financial flexibility.

(*Continues on next page*)

Categorization of Organizations in the Business Sector: Forprofits

- **Forprofit corporations (*continues*):**
  - Conversely, close corporations are typically a bit smaller and face a bit more relaxed auditory requirements than public corporations. There are none conventional market shares of close corporations, resulting in more financial rigidity.
  - In Norway, public and close corporations are represented by aksjeselskap (AS) and allmenn aksjeselskap (ASA), respectively.
  - In addition, Norway also has transnational stock companies inside EEA and foreign companies Norwegian division, Norskregistrert utenlandsk fortak (NUF), which usually are organized as stock companies
  - In order to prevent fraud, an AS' initial stock of capital must be at least NOK 30,000, and the access to pay out dividends are limited.
  - Similarly, an ASA's initial capital stock must be at least NOK 1,000,000, and the access to pay out dividends is strict. What is more, ASAs are obligated to have an operative manager and a board of at least three persons.

Categorization of Organizations in the Business Sector: Legal Based Categorization of Nonprofits

- **Foundations:**
  - A *foundation* constitutes a legally independent person, which are set up by a person or a group of private persons through a testament, which forms the ground rules and the purpose of the organization.
  - In Norway, a foundation is known as a *stiftelse*. Norwegian law distinguish between ordinary foundations and business foundations, where the latter face stricter auditory and financial restrictions.
  - Saving banks constitute a special case within the group of business foundations, having an own legal form in many countries.
  - Public foundations are often established by the public sector to achieve less political sensibility and more independency for a given purpose.

Categorization of Organizations in the Business Sector: Legal Based Categorization of Nonprofits

- **Foundations:**
  - The categorization of foundations in the literature seems somewhat inconsistent. I propose to divide foundations as following:
    - **Interest foundations** protects the interest of larger mutual groups or advocate the narrow interest of a small group
    - **Charity foundations** engages in charity in philanthropic activities-
    - **Business foundations** engages in commercial activities. They are industrial foundations, when they own private companies.
    - **Hybrids foundations** is hybrids between the three former forms.
- In addition, we distinguish between foundations **public foundations** and **private foundations**, depending on their source of finance.

Categorization of Organizations in the Business Sector: Legal Based Categorization of Nonprofits

- **Associations:**
- Associations constitute a diverse group of organizations in both scale and scope.
- They are usually less involved in business activities than foundations, and control rights are commonly obtained by membership.
- Associations are commonly bound from distributing profits.
- Non-governmental organizations are sometimes used as term for associations independent of the government.
- More generally, non-governmental organizations are commonly divided after orientation (charitable, empowering, participatory and service) and level of cooperation (community based, city wide, national and international).
- Non-governmental organizations are occasionally treated as an own group of third sector entities, rather than a subgroup of nonprofits.
- In Norway, the general associations are registered as *foreninger*, of whom some are subject to specific laws.

Categorization of Organizations in the Business Sector: Legal Based Categorization of Nonprofits

- **Cooperatives:**
  - *Cooperatives* are characterized by membership control and ownership, as well as distribution of the surplus to their members.
  - Their members can constitute a wide range of beneficiaries, including customers, retailers, workers and residents.
  - In a worker cooperative, the workers' utility from inducing effort and gaining money is maximized, possibly overcoming moral hazard issues.
  - In a consumer, the market surplus is maximized for the sake of the consumer, and so on.

(*Continues on next page*)

Categorization of Organizations in the Business Sector: Legal Based Categorization of Nonprofits

- **Cooperatives (*continues*):**
  - Due to their distribution of profits, many authors recognize cooperatives as forprofit rather than nonprofits. For instance, there are few substantial differences between a working cooperative and a private partnership where everyone is partners. Yet, cooperatives generally seek to serve broader core interests than just profits.
  - In Norway cooperatives are legally organized as a *Samvirkeforetak (SA)* with full liability or as an *European Cooperative* with a valid legal form in the whole EEA. An earlier legal form with limited liability, *Samvikeforetak med begrenset ansvar (BA)*, will be closed from January 1st 2013.

Categorization of Organizations in the Business Sector: Legal Based Categorization of Nonprofits

- **Mutuals:**
  - Money-distributing nonprofits is called *mutual companies* or just *mutuals*, encompassing inter alia mutual insurance companies and mutual savings banks.
  - While cooperatives are owned by their beneficiaries, mutuals are legally independent persons, like foundations.
  - As for cooperatives, many authors do not recognize mutuals as nonprofits, because they violate the non-distribution constraint.
  - In Norway, mutuals are legally organized as bank foundations, insurance foundations or an ordinary foundation with statutory objectives directed toward a particular beneficiary group's well-being.

Categorization of Organizations in the Business Sector: Aim Based Categorizations of Nonprofits

- Weisbrod's categorization:
  - **Clubs** dedicated to provide some kind of benefits for their members.
  - **Collective-type nonprofits** produce public services to the benefit of its
  - **Trust-type nonprofits** provide costly, trustworthy and valuable information to its outside beneficiaries.
  - **'Forprofits in disguise'** nonprofit legal status is chosen to realize business options
- Ware's categorization:
  - Ware refer to third sector actors as 'intermediate organizations' and claims that 'nonprofit' is a blurry term of third sector actors operating in the business life that cut across his categories.
  - Ware divide the third sector into charities, mutual organizations, political groups and associations.

Categorization of Organizations in the Business Sector: Aim Based Categorizations of Nonprofits

- Hansmann's categorization:
  - Hansmann divide nonprofits along two dimensions based on activities and control:
    - Activities: **Donative nonprofits** depend on funding, whereas **commercial nonprofits** are financed by commercial activities.
    - Control: **Entrepreneurial nonprofits** are controlled by managers, while **mutual nonprofits** are controlled by stakeholders.
  - Hansmann excludes cooperatives and mutual companies from his definition of nonprofits, since they violate his non-distribution constraint (i.e. they are allowed to distribute profits).
- Bielefeld and Galaskiewicz classify nonprofits into four groups based on the strength of their output and process controls.
- Ben-Ner, Gui and Van Hoomissen classify nonprofits based on their rationale, following from demand and stakeholder (confer the stakeholder approach).

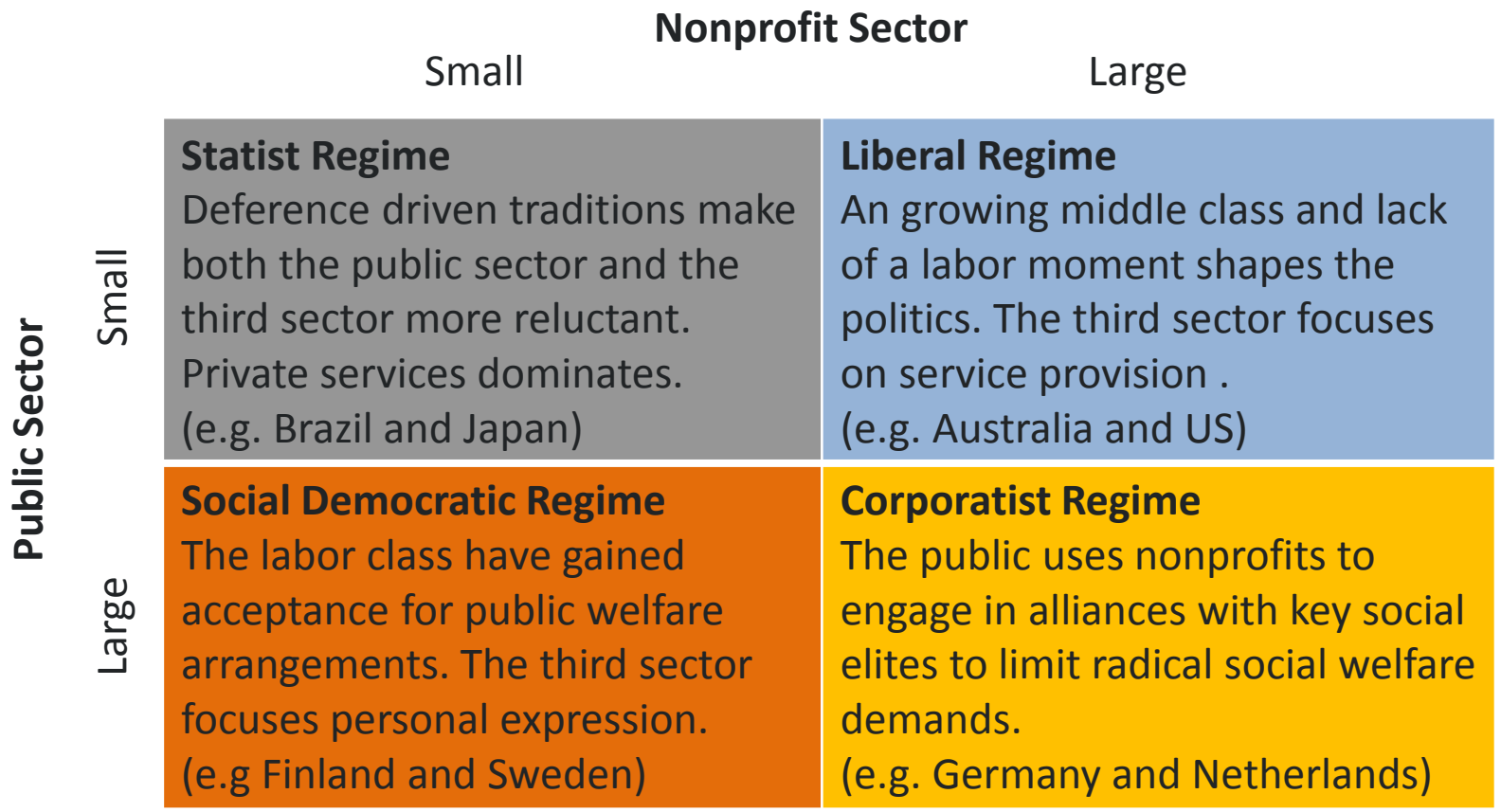
Content

- Introduction
- Categorization of Organizations in the Business Sector
- The Nonprofit Landscape
- Theory of Demand for Nonprofits
- Theory of Supply for Nonprofits
- Nonprofit Incentive Structure
- Financing of Nonprofits
- Conclusion

The Nonprofit Landscape:
A Glimpse of the Nonprofit Sector's History

- Since ancient times, people have formed and joined societies to ensure mutual interests and distributive justice.
- Buddhist temples and ministries in Ancient China provided social services, including feeding stations for poor people, hospitals and nursing homes.
- In Europe, the states remained weak for more than a thousand years after the Roman collapse, and nonprofits faced difficulties in providing alleviation in case of disasters.
- Mutual benefit organizations other than protection guilds remained difficult to establish up to the renaissance. The world's third sector was largely philanthropic, with the Catholic Church as a driving force in Europe.
- During the renascence, the European churches were supplemented by other philanthropies, and gradually, also by mutual nonprofits. The trade unions' forerunners started to become common around 1700, while cooperatives emerged throughout the preceding century.
- In the mid-1800s, corporations seized the position as the prevailing Western business-related institutional form. Yet, nonprofits continued possessing significant sectorial shares in many sectors.

The Nonprofit Landscape: Social Origin Approach



The Nonprofit Landscape:
The Modern Nonprofit Landscape of the World

- Johns Hopkins Comparative Nonprofit Sector Project (John Hopkins) shows that around three fourths of the voluntary based nonprofit sector expenditures worldwide are related to four major fields.
- Key findings (1995) (excluding not volunteer-based nonprofits):

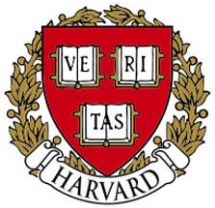
The Voluntary Sector (1995)	Germany	Sweden	US	Japan
Paid employment, percentage	4,9	2,6	7,8	3,5
Percent of adult population volunteering	26	51	49	12 (1990)
Operating expenditure as percentage of GDP	3.6	3.2	6.4	3.3
Nonprofits per 100,000 inhabitants	456	1,463	412	76

- These are culture and recreation (e.g. arts, media, service clubs and sports), health (e.g. hospitals and nursing homes), knowledge (e.g. education and research) and social services (e.g. child care, emergencies, income support and refuge assistance).
- John Hopkins excludes political and religious nonprofits, as well as nonprofits without a voluntary feature.
- Other important fields includes banking, certification, diary and insurance.
- The third sector strongest growth today is in the third world.

The Nonprofit Landscape:
The Modern Nonprofit Landscape of the World

- In general, the first decade of the 21st century was characterized by continuing global expansion of the nonprofit sector. The growing demand for nonprofits was accompanied by weaker public finances.
- When the global financial crisis hit the world economy in 2008, donations to and voluntarism in nonprofits was impeded, whereas Keynesian policies increased the public sector, suppressing the nonprofit sectors even more.
- Due to large public deficits, however, the public sectors soon dismantled in many developed countries, implying increased demand for nonprofits. Yet, the required rates of return for nonprofits have generally increased.
- Nonprofits are rather innovative and adaptive to technological changes, but these strengths are limited by their resource restrictions.
- In Denmark, foundations own and operate about a quarter of the country's hundred largest companies and control close half of the major Danish stock index's (KFX) value (Hansmann and Thomson 2009).
- Similar structures were usual in the United States up a law introduction in 1969, which prevented and still prevents foundations in the country from owing more than twenty percent of business companies (ibid.)

The Nonprofit Landscape:
The Modern Nonprofit Landscape of the World



The Nonprofit Landscape: Norwegian Nonprofits


The Nonprofit Landscape: Predictions of Future Trends

- Ante financial crisis prediction:
  - Increased competition or more regulations will decrease the presence of nonprofits in some traditional nonprofit industries (Ben-Ner and Gui 2003).
  - Less government provision of welfare services and increased demand for immaterial, sophisticated and relational goods would increase the demand for nonprofits (ibid.).
  - The nonprofit's expansion would according to the authors be limited by supply through lack of entrepreneurs and donors (ibid.)
  - More privatization, new public management and need for innovations related to social services would result in major challenges for the sector (Anheier 2003).
  - Nonprofit would face an increasingly demand from a variety of stakeholders, and that they would take over tasks from both the private and the public sector (ibid.).

(Continues on next page)

The Nonprofit Landscape: Predictions of Future Trends

- Ante financial crisis prediction (*continues*):
  - Decreased government support will push nonprofits into commercial activities. Thus, nonprofits will become more similar to forprofits; particularly in the United States (ibid.).
  - I believe these predictions remains strong today.
- My own prediction:
  - If the public deficits and aging populations force developed countries to downsize their public sectors, it seems reasonable to expect that the demand for nonprofits would grow. These trends are less striking for certain parts of Northern Europe, where the debt issues are less prevalent(Holmen 2012).
  - Lastly, I predict that economic progress will increase the nonprofit sectors in developing countries. In many Arabic countries, democratization is likely to contribute to larger nonprofit sectors (ibid.).

Content

- Introduction
- Categorization of Organizations in the Business Sector
- The Nonprofit Landscape
- Theory of Demand for Nonprofits
- Theory of Supply for Nonprofits
- Nonprofit Incentive Structure
- Financing of Nonprofits
- Conclusion

The Theory of Demand for Nonprofits: Public Good Approach

- Weisbrod formulated his path-breaking public good approach in his influential paper '*Toward a Theory of the Voluntary Nonprofit Sector in a Three-Sector Economy*' from 1975 (revised in 1988).
- The public sector will have to take the median voter into account in terms of his willingness to pay taxes and his demand for different public goods. The government's provision of public goods is determined accordingly.
- Furthermore, public goods are typically not provided by forprofits due to a combination of the free-rider problem of public goods and forprofits' perverse incentives from the donors point of view.
- Consequently, Weisbrod stresses that efficiency, in the sense that the social marginal benefit equals the marginal cost of production for social beneficial goods, is unlikely to be fulfilled.
- In his 'government failure argument', Weisbrod highlights nonprofits' ability to supply of certain public goods; a supply that forprofits and public enterprises largely fail to provide. Nonprofits could overcome the free-rider problem and satisfy the unsaturated demand of public goods through social glows, social pressure and altruism.

Theory of Demand for Nonprofits: Public Good Approach

- An important implication of Weisbrod's model is that it predicts that the nonprofit sector will be larger in communities with more heterogeneous preferences among the inhabitants.
- Empirical research indicate that the nonprofit sector is larger, when there are demographic characteristics such as age, education, income and ethnical background varies more (Kingma 2003).
- Extensions of the public good approach:
  - Many of the extensions of the public goods approach embraces integration with other approaches, including the entrepreneurship approach, the trust approach and the stakeholder approach
  - One may apply more sophisticated political conducts than the median voter assumptions.
  - Model the output as a private good with a positive externality, rather than a public good, allowing forprofits and nonprofits to compete.
  - Public goods could be financed through cross-subsidization, rather than donations.

Theory of Demand for Nonprofits: Public Good Approach

- I will now review my extended version of Weisbrod and Schiff (1991) and James (1983) models (Holmen 2012).
- I let the nonprofit have a utility function, $U(z, x)$, where *z* is some public good, which the nonprofit provides, with $U'_z > 0$, and *x* is a private good, which is sold to an exogenous market price, *p*.
- I suggest that the underlying rationale behind this could be that the management's utility function actually depends on the directors' fee, $F = F(x, z)$, where $F'_1(x, z) \leq 0$, and $F'_2(x, z) > 0$, such that $U'_F > 0$.
- I introduce the following non-distribution constraint:

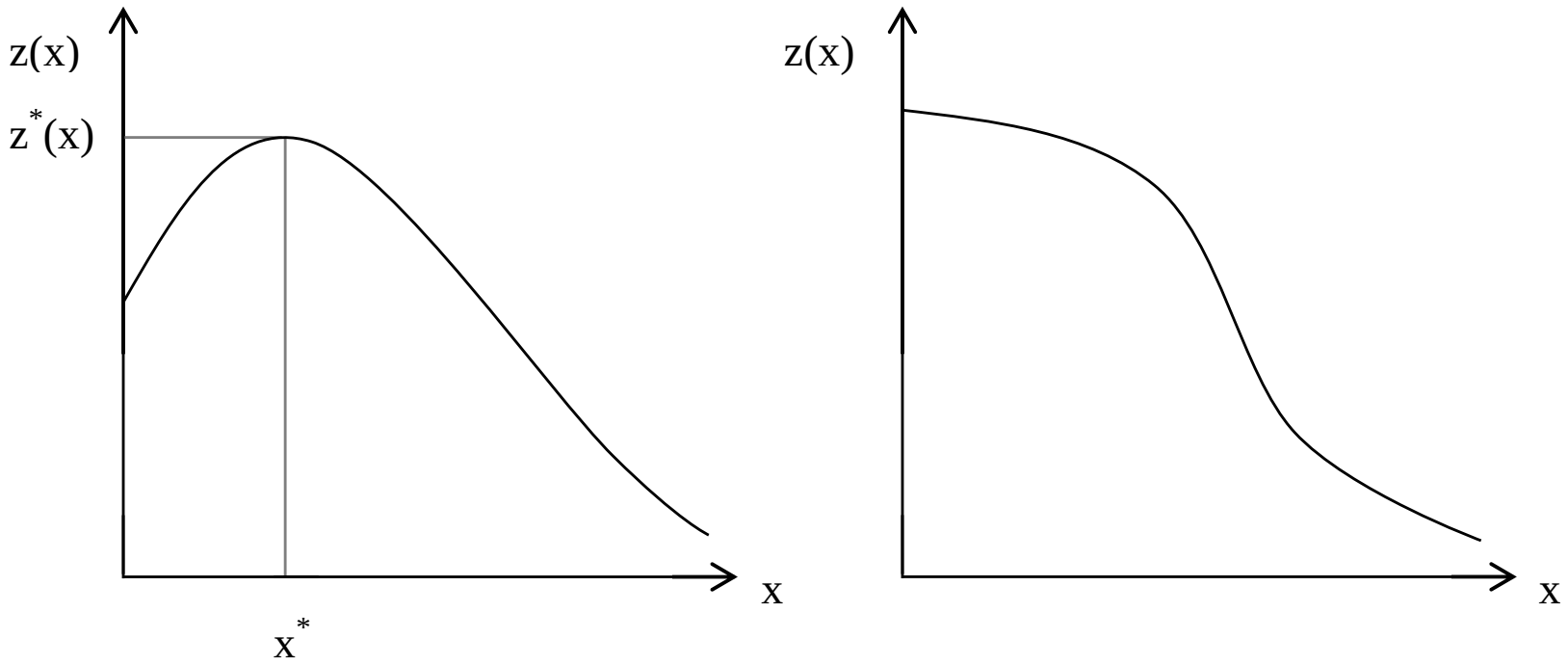
$$D(z, x, S) + px - C(z, x) - S = \bar{F}$$

where $\bar{F}$ is a fixed director's fee, *S* is the solicitation expenditures, $D(*)$ is the donations and $C(*)$ is the firm's cost function.

Theory of Demand for Nonprofits: Public Good Approach

- We assume that the cost function is increasing and concex in the production; that is $C_i' > 0$ and $C_{ii}'' > 0$ for $i \in \{1,2\}$.
- We assume that the donations is increasing and convex in both solicitation costs and the public good, i.e. $D_1' \leq 0$, $D_{11}'' \leq 0$, $D_3' > 0$ and $D_3'' < 0$.
- Mathematically, z could be expressed as a quasiconcave function of x, with the cost function, the donation function and the non-distribution constraint as the underlying bases.
- Although the non-distribution our defined constraint implies that there could be dominating synergic effects between x and z, I assume that an increase in one of them eventually implies a decrease in the other to secure that the problem has a solution.

Theory of Demand for Nonprofits: Public Good Approach



The figure illustrates two possible relationships between *x* and *z*. The graph in the left panel assumes that there is a positive relationship between *x* and *z* until a turning point, before the relationship becomes negative, whereas the graph in the panel to the right assumes that the relationship is negative for all positive values of *x* and *z*.

Theory of Demand for Nonprofits: Public Good Approach

- The nonprofit's maximization problem becomes:

  $U(c) = \max_{z,x} U(z,x)$ subject to $D(z,x,S) + px - C(z,x) - S = \bar{F}$

- The corresponding Lagrange function follows:

  $$\mathcal{L} = U(z,x) - \lambda(D(z,x,S) + px - C(z,x) - S - c)$$

- From the envelope theorem, we have that $U'(F) = -\lambda$, implying that the shadow price for the directors' fee must be negative.

- The first order conditions become:

  - $U'_z - \lambda(D'_z - C'_z) = 0 \rightarrow \lambda = \frac{U'_z}{(D'_z - C'_z)} < 0$

    The costs increase more than the donations, when the provision of the public good increases (i.e. $D'_z < C'_z$).

(*Continues on next page*)

Theory of Demand for Nonprofits: Public Good Approach

- The first order conditions become (*continues*):
  - $U'_x - \lambda(D'_x + p - C'_x) \Rightarrow \frac{U'_x}{\lambda} = (D'_x + p - C'_x) \leqq 0$
    The quantity chosen is not just a matter of marginal cost and prices, but also depends on the valuation of x, the effects on donations from commercial activities and the shadow price for the director's fee.
  - $-D'_S + 1 = 0 \Rightarrow D'_S = 1$
    In optimum, one more krone used on solicitation gives exactly one more krone of donations.
- Eliminating λ from the two first conditions yields:

$$C'_x = p + D'_x - \frac{U'_x}{U'_z}(D'_z - C'_z)$$

x's marginal cost must be equal to *x*'s marginal benefit, in terms of sales, donation impact and the utility weighted net cost reduction of *z*.

Theory of Demand for Nonprofits: Public Good Approach

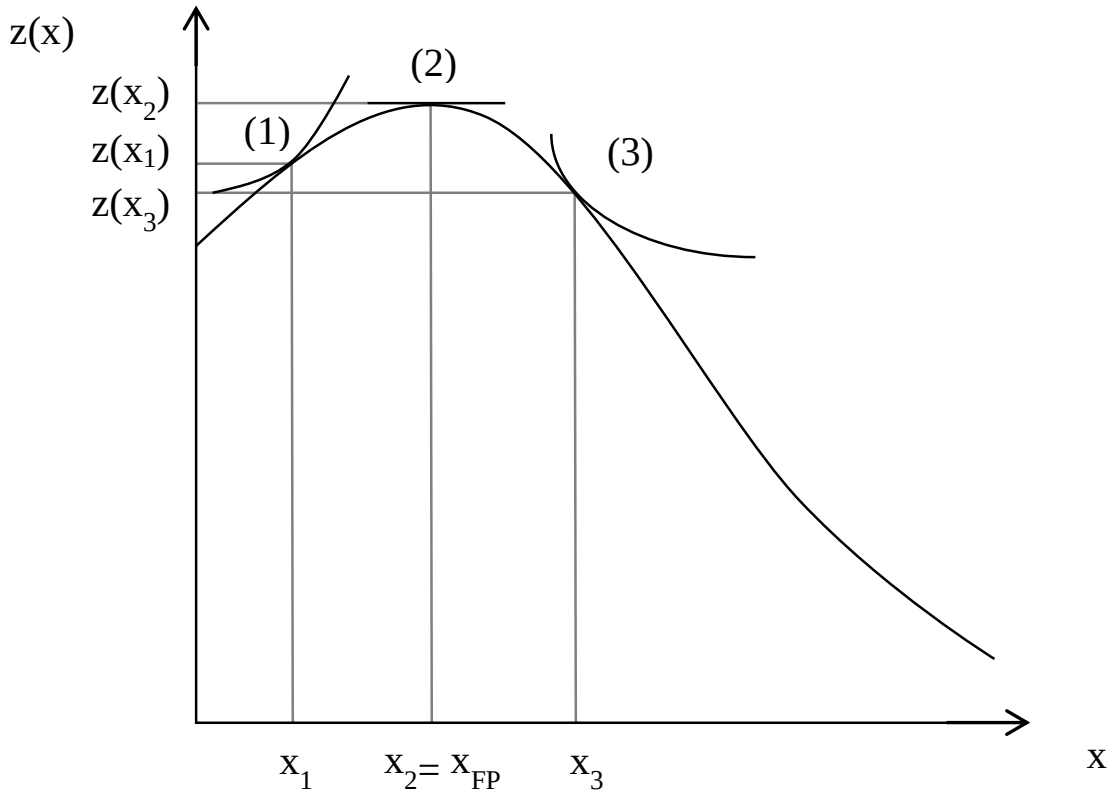
- Crowding effects will impact the choice of quantity:
  - If $D'_x < 0$ and $U'_x = 0$, we get $C'_x < p$, i.e. the nonprofit sets a lower quantity of the private good than the forprofits, due to a crowding out effect on donations.
  - If $D'_x = 0$ and $U'_x < 0$, we get $C'_x < p$, i.e. the nonprofit sets a lower quantity of the private good than the forprofits, due to a contempt for commercial activities within the nonprofit.
  - If $D'_x = 0$ and $U'_x > 0$, we get $C'_x > p$, i.e. the nonprofit sets a higher quantity of the private good than the forprofits, because it perceives commercial activities as beneficial for the society.

(*Continues on next page*)

Theory of Demand for Nonprofits: Public Good Approach

- Crowding effects will impact the choice of quantity (*continues*):
  - If $D'_x = 0$ and $U'_x = 0$, we get $C'_x = p$, i.e. the nonprofit adapts similarly as the forprofits in the market for the private good.
  - If $D'_x < 0$ and $U'_x < 0$, we will have $C'_x < p$, where both a commercial crowding effect and the management's aversion against commercial activities contribute to a low quantity of x.
  - If $D'_x < 0$ and $U'_x > 0$, the crowding out effect of commercial activities and the management's utility from production of the private good will give two contradictory effects, leaving the price level ambiguous.
  - I neglect the possibility of crowding in effects from commercial activities due to for instance a more professional image.

Theory of Demand for Nonprofits: Public Good Approach



The figure shows three different cases. In case (2), there are no crowding effects, and the management does not care about the private good, so the quantity is the same as for the forprofit firms (given that the scale advantages are the same). In case (1), the management dislikes the private good and/or a crowding in effect is dominating, so that the quantity is set lower than the forprofit. In case (3), the management cares for the private good and/or a crowding in effect is dominating, so that the quantity is set higher than for the forprofit.

Theory of Demand for Nonprofits: Public Good Approach

- Donative nonprofits:
  - For pure donative nonprofits, the optimal solution simplifies to $D'_z(z, 0, S) = C'_z(z, 0)$ and $D'_S(z, 0, S) = 1$, i.e. marginal cost must equal marginal benefit for both public good provision and solicitation.
- Forprofits:
  - We assume that the donors prefer to support nonprofits, possibly due to the fact that nonprofit, unlike forprofit, lack the incentive to provide less public goods than they promise, such that $D_{FP} = S_{FP} = 0$.
  - We get the standard condition, $p = C'(0, x)$, assuming no synergy effects in the productions of z and x, or these effects are too small to cover the start-up costs for providing z.

Theory of Demand for Nonprofits: Public Good Approach

- Non-donative nonprofits:
  - Per definition $D = S = 0$ for non-donative nonprofits. Thus, the solution becomes:

$$C_x' = p + \frac{U_x'}{U_z'} C_z'$$

    Whether nonprofit's marginal costs will be above, below or equal to the price will depend on the sign of U_x'.

  - In order for the non-donative nonprofit to both survive the competition and provide the public good, it will need a competitive advantages, such as synergies between the productions of x and z:
    - Forprofit are unable to imitate nonprofits, deriving from scale and scope advantages obtained due to substantial public or private start-up support to nonprofits, or forprofit's myopia.
    - Synergies in productions the of *x* and *z* could descend from the labor market (confer the green worker theory).

Theory of Demand for Nonprofits: Public Good Approach

- Integration of green worker theory:
  - Workers are willing to accept lower wages than normal, if they perceive their employer as a promoter of the common good (confer section about green worker theory).
  - I claim that the theory is relevant for the third sector and propose to integrate the theory formally as a supply rationale for the model.
  - I adopt Frank's (2009) assumption that the workers' wage ($w(*)$) is a decreasing function of the employers' provision of the public good (i.e. $w'(z) < 0$).
  - I dismiss the possibility of forprofit provision of the public good by assuming that the forprofits are regarded less credible as public good providers, due to their profit incentives.
  - The cost function becomes $C(z, x) = w(z)L(x, z)$, where the labor input increases with the production of the two goods (i.e. $L'_1(z, x) > 0$ and $L'_2(z, x) > 0$).
  - *Continues on next page*

Theory of Demand for Nonprofits: Trust Approach

- In his influential paper *The Role of Nonprofit Enterprise*, Henry Hansmann (1980) launches the trust approach to nonprofits, where the rationale behind nonprofits was based on trust-arguments.
- Hansmann's model's starting point is asymmetric information in the sense that the consumers cannot verify whether a good have been supplied at all, and if it was supplied at sufficient quality or quantity.
- Such problems could arise; when it is difficult to verify the level or quality of a provision for a court of law; when the consumer is not the same person as the one who pays for the good; and moreover, when one are dealing with certain complex personal services.
- Hansmann was the one who introduced the non-distribution constraint, which defines nonprofits as organizations prohibited from distributing their surplus.

Theory of Demand for Nonprofits: Trust Approach

- Due to the non-distribution constraint, nonprofits lack the profit incentive for shirking on quality to earn a surplus, which make them more credible as quality providers than forprofits from the consumer's point of view.
- One may say that nonprofit organizational status functions as a signal for trust, solving the information problem between consumers and producers.
- Nonprofits provide an imperfect guarantee for the demand side against an exploitation of the asymmetric information from the supply side.
- Hansmann (1996) suggest that nonprofit ownership is optimal, when the conflicts between the market contractual costs and ownership costs are too strong for efficient individual ownership.

Theory of Demand for Nonprofits: Trust Approach

- Extensions of the trust good approach:
  - The non-distribution constraint not only makes nonprofits more trustworthy when selling goods, but also provides a leeway for generous impulses of donors and expiry of ideological belief.
  - Combination with the trust approach: both trust and provision of information could be considered as collective goods, and that a nonprofit status could act exactly as a signal of this kind.
  - I believe the theory also have predictive power in labor market for complex and creative services, where some of the advanced and inspiring tasks do not generate income per se
  - I propose to combine the trusts approach with green consumer theory (confer the slide about green consumer theory).

Theory of Demand for Nonprofits: Trust Approach

- Green consumer theory encompasses that some ‘green consumers’ have higher willingness to pay for goods that they perceive as corporate social responsible.
- Lowrey et al. (2005) apply information problems as a possible reason for why green consumers prefers corporate social responsible firms.
- In my opinion, the missing link between the trust approach and green consumer theory is that nonprofits may appear more corporate social responsible than forprofits, since they are largely are established in order to promote the common good, rather than earning profit.
- I believe Hansmann’s argument would be a special case of the green consumer perspective.
- There could also be other reasons for green consumers, inter alia altruistic features in the preferences or a social glow of giving.

Theory of Demand for Nonprofits: Trust Approach

- Application of green consumer theory on nonprofits:
  - Take for instance a ‘fair trade product’.
  - If I buy a fair trade product, which is more expensive than similar ordinary products, it is not because of the respective company’s legal status. I do it to support the poor workers who contribute to making the products.
  - Yet, if the company is neither a nonprofit nor is authorized by some fair trade association, I might be skeptical to whether my extra payment actually reaches the less fortunate workers.
  - Moreover, the forprofits’ profit motivation may make me fear that they will try taking some of the exceeding payment from fair trade products and put them in their own pockets.

Theory of Demand for Nonprofits: Stakeholder Approach

- Stakeholder theory highlights how various stakeholders with coinciding and conflicting interests affects and are affected by an organization.
- During the 1990s, Ben-Ner adapted the stakeholder approach to nonprofits with various co-authors, including Gui and Van Hoomissen.
- Moreover, nonprofits could provide a leeway for various stakeholders to secure their interests (e.g. board of directors, consumers, donors, founders, managers and workers).
- Compared to forprofits, nonprofits are more suited for creating favorable environment for social interaction, more able to host satisfactory personal relationships for ultimate organizational control and have easier facilitate a sense of belonging and thereby a good environment for coordination.
- The stakeholder provides a way to structure the other approaches. It involves both internal and external stakeholders, so although the demand side often gets much attention, it is not a pure demand side theory.
- Weisbrod's public good approach and Hansmann's trust approach, as well as many other approaches, are consistent with the stakeholder theory, albeit as partial approaches.

Theory of Demand for Nonprofits: Stakeholder Approach

- The stakeholder approach provides seven rationale for nonprofits, depending on governance failures and market failures:
  - Informational advantage over its consumers or suppliers, regarding some characteristics of a transaction.
  - From the stakeholders perspective, monopolies could charge too high prices and too low quality. The opposite holds for monophonies.
  - Systematically discrimination against some stakeholders grounded in demographic and social characteristics irrespective of productivity.
  - Hidden characteristics among beneficiaries could create problems like adverse selection.
  - Public goods provision entails two problems; sellers underprovide the good and buyers underreport their willingness to pay.
  - Club goods involves similar market failures and governance failures as public goods, albeit the problems are relaxed.
  - Relation goods: A significant amount of people's utility and motivation stems from relations.

Content

- Introduction
- Categorization of Organizations in the Business Sector
- The Nonprofit Landscape
- Theory of Demand for Nonprofits
- Theory of Supply for Nonprofits
- Nonprofit Incentive Structure
- Financing of Nonprofits
- Conclusion

Theory of Supply for Nonprofits: Entrepreneurship Approach

- The entrepreneurship approach, developed by Dennis Young in the 1980s, highpoints nonprofits as an alternative under institutional choice.
- Nonprofits are either set up by a entrepreneur or a testament. Entrepreneurs could both be institutions and private persons.
- A lesson from the entrepreneurship approach is that altruistic and egoistic goals are decisive for the extent and nature of nonprofit entrepreneurship
- The approach asserts the dynamics of innovation and reorganizing.
- Recent literature does also emphasize qualitative insights on the practical management and degree of professionalism in a given firm.
- Personal motivation could both be grounded on process oriented factors (e.g. need for independence and personal development) and more outcome-oriented motives (e.g. pride for creative accomplishments and search for power).
- Generally, perquisites are less appreciated than their monetary value. If the nonprofit have unique business prospect, a nonprofit institutional choice could be preferable from a egocentric monetary-seeking stand.

Theory of Supply for Nonprofits: Voluntary Failure Approach

- The voluntary failure approach was developed by Lester Salamon in the 1980s and holds strong links to the social origin approach.
- In traditional nonprofit theory, the third sector is considered as something between the public and the forprofit sector. Its role is primarily to supplement the public sector.
- The voluntary failure approach rejects this view. Instead, it claims that the third sector is the first to deliver social beneficial goods that the forprofits fails to provide. The government role is primarily to compensate for the third sector's shortcomings, depending on the welfare regime in question.
- Market and governing failures prohibiting forprofit provision could be lasting (e.g. insufficiency failures, particularism and localism) or remedied over time (e.g. amateurism, paternalism and organizational failures).
- Wolpert extends the approach to involve three incremental components: 1) The quanta of nonprofit provision depending on comparative advantages; 2) the nonprofit-public partnership, which exploits the nonprofit sector' autonomy and public sectors' general perspective; and 3) the dynamic interaction between the two sectors.

Theory of Supply for Nonprofits: Organizational Behavior Approach

- Evolutionary economics involves two
  - Darwinian approach – evolution through selection
  - Lamarckian approach – evolution through adaption
- The organizational behavior approach was developed by Wolfgang Bielefeld and Joseph Galaskiewicz in the 1990s, and brings in insights from evolutionary economics.
- The approach shows how nonprofits' priorities and tactics can be the best response to various dynamics in the surroundings.
- Rather than drawing attention to organizational outputs and outcomes, they highlight variations in priorities and tactics.
- The theory underpins that organizations not only compete, but also cooperate
- Thus, forprofits' and nonprofits' behavior may either converge or self-select to different niches, when both institutional forms survive in the competition.

Content

- Introduction
- Categorization of Organizations in the Business Sector
- The Nonprofit Landscape
- Theory of Demand for Nonprofits
- Theory of Supply for Nonprofits
- Nonprofit Incentive Structure
- Financing of Nonprofits
- Conclusion

Nonprofit Incentive Structure: Property Right Approach

- In contrary to the demand side of nonprofits, the supply side have not been properly studied.
- In this section, I will highlight nonprofits' interior challenges and their ability counter these by behavioral and non-behavioral mechanisms. This analysis does largely comply with the property right approach.
- Nonprofits' Adaption:
  - Nonprofits promote the desires of their beneficiaries, driven by different degrees of altruistic and egoistic motives.
  - Although some nonprofits are able to distribute profits (e.g. cooperatives and mutuals), most nonprofits are restricted from doing so. Thus, profits become a restraint (i.e. the non-distributional constraint) rather than the objective itself.

Nonprofit Incentive Structure: Property Right Approach

- Distribution of Control Rights:
  - In contrary to forprofits, nonprofits have no owners (except for cooperatives) and thereby no obvious principals with strong incentives to control the operations.
  - Nonprofits are typically controlled by different stakeholders to a various degrees (e.g. customers, donors, founders, management, board of directors and workers).
  - Founders and donors would like to ensure that their grants are utilized in line with their intention. This could be achieved partly or wholly through ex ante objective focus (e.g. founding testament or legal commitments) or ex post control focus (e.g. right to appoint board members or project management).
  - Seek for finance often affects the nonprofits operations through differences profit prospects and change in distribution of power between stakeholders.

Nonprofit Incentive Structure: Opportunistic Behavior

- Moral Hazard:
  - In traditional principal-agent theory, the owner ensures that a rational and selfish manager induce effort and do not shirk, when the manager's effort is not directly verifiable for the owners.
  - The manager will have to base the manager's payment on another variable that is both verifiable and closely linked to the manager's level of performance, given that it does not make the manager extensively neglect other unverifiable work assignments.
  - The fact that incentives are costly to implement will often result in that the principal choose a second-best solution, with lower effort for the manager than in a first-best solution without information problems. This phenomenon is known as moral hazard.
  - There are no obvious principals in nonprofits, at least not ex post establishment. If the manager is rational and selfish, and are not object to disciplinary mechanisms or behavioral characteristics, one should therefore expect nonprofits to be dominated by moral hazard.

(*Continues on next page*)

Nonprofit Incentive Structure: Opportunistic Behavior

- Moral Hazard (*continues*):
  - It may well be that the performance of a nonprofit manager is observable, after implementing the project. Nonetheless, the manager's contract can not be based on this observation, since the founder looses control, when the nonprofit is established.
  - Yet, the founders and donors might act as ex ante principals, whereas a carefully appointed board of directors and legal schemes may follow up opportunistic behavior.
- Rent-Seeking:
  - A possible threat for nonprofits is that unscrupulous insiders could exploit nonprofit's name to consumers' disadvantage.
  - In the worst case, 'the bad guys are taking over'-scenario will come to play, where the nonprofit are invaded by intruders for rent-seeking purposes.

Nonprofit Incentive Structure: Opportunistic Behavior

- Empirical findings on opportunistic behavior:
  - Nonprofits occasionally have lower remunerations than their public counterparts, but generally larger than their forprofit competitors (Bielefeld and Galaskiewicz 2003).
  - Historically, Western nonprofits, and in particular European nonprofits, have struggled with unprofessional managements (Badelt 2003).
  - Nonprofits ran by idealistic leaders are vulnerable to changes in the management (Bhatnagar and Nair 2011)
  - Empirical evidence indicate the control mechanisms work in most foundations, but are dysfunctional in a significant portion. Smaller foundations are the ones most exposed to internal irregularities (The Norwegian Gambling and Foundation Authority 2012).
  - In 2011, The Norwegian Foundation Authority had about 400 cases about irregularities in foundations for above 8,000 foundations (ibid.). In comparison, the supervision had above 800 cases for about 8,500 in 2010 (Mauren 2010).

Nonprofit Incentive Structure: Non-Behavioral Control Mechanisms

- The non-distribution constraint is most often supplemented by a set of disciplining constraints to prevent moral hazard and rent-seeking, and to ensure that the nonprofit's objective is pursued.
- Non-behavioral interior control mechanisms:
  - Specify procedures for the nonprofits operations and strategic choices in the foundation document or other legal statements
  - Ensure the appointment of an independent board of directors, which can follow up the nonprofit's aim.
  - Circular control mechanisms (confer my own Game of Internal Control) or crossing control mechanisms (a more complex system with crossing control lines)

Nonprofit Incentive Structure: Non-Behavioral Control Mechanisms

- Non-behavioral exterior control mechanisms:
  - Job reputation and career opportunities
  - Self-selection of workers and management
  - Hired external inspectors
  - Public law and supervision
  - Ability to raise capital
- The non-behavioral control mechanisms are interlinked and supplemented by behavioral control mechanisms.

Nonprofit Incentive Structure: Game of Internal Control

- Motivation for the game (Holmen 2012):
  - Nonprofits need control systems to prevent opportunistic behavior. The game is meant to illustrate how these may or may not work.
  - By circular control, nonprofits are able to cope with internal problems without any behavioral rationales, by letting different divisions of the organization control each other in circles.
- Setting up the model:
  - Let there by three teams; *team A*, *team B* and *team C*.
  - We assume that all the teams are rational and egoistic, in the sense that they want to, and know how to, maximize their own payoffs.
  - The game is assumed to be static and played simultaneous.
  - We let team i be controlled by team $J(i)$ with $i \in \{A, B, C\}$, where $J(A) = C, J(B) = A$ and $J(C) = B$.

(*Continues on next page*)

Nonprofit Incentive Structure: Game of Internal Control

- Setting up the model (*continues*):
  - Each team can either choose to…:
    - … induce effort (E_i), implying that it inspects the team it is supposed to inspect, contribute to the common pot, face a cost of inducing effort and face no cost when being inspected.
    - … shirk (S_i), implying that it skips inspection of the it is set to watch after, do not contribute to the common pot, face no effort cost and face a cost when being inspected.
  - The common pot is given by $CP = \mu \sum_{j=1}^{n=3} P_j$, where μ is the return factor for contribution and P_i is a dummy for effort, which takes the value $P_i = 0$ when team i shirks, and the value $P_i = 1$ when team i induces effort. In my example, I set $\mu = 6$.

(*Continues on next page*)

Nonprofit Incentive Structure: Game of Internal Control

- Setting up the model (*continues*):
  - I set team *i* cost of inducing effort and inspect equal to 3 when $P_i = 1$ and 0 when $P_i = 0$.
  - We introduce a dummy for being caught shirking in inspection $C_i\left(P_i, P_{J(i)}\right)$, which takes the value one being caught shirking (i.e. $C_i(0,1) = 1$) and the value zero otherwise (i.e. $C_i(0,0) = C_i(1,0) = C_i(1,1) = 1$).
  - Team *i*'s payoff becomes:

    $$\pi_i = \frac{CP}{3} - 3P_i - 3C_i\left(P_i, P_{J(i)}\right) = 2\sum_{j=1}^{n=3} P_j - 3I_i - 3C_i\left(P_i, P_{J(i)}\right)$$

    where $i \in \{A, B, C\}$

Nonprofit Incentive Structure: Game of Internal Control

- Solving the model:
  - If none of the teams induces effort:
    - When none of the teams induces effort, neither of them will derive incomes nor costs, such that all payoffs will be zero.
    - None team will regret there choice of action given the other teams' adaptions. A change of strategy would imply a income of two and a cost of inducing effort of three, summing down to a payoff of minus one.
    - It is therefore obvious that it is better to shirk. It follows that the action set $\{S_A, S_B, S_C\}$ is a Nash equilibrium.

(*Continues on next page*)

Nonprofit Incentive Structure: Game of Internal Control

- Solving the model (*continues*):
  - If one of the teams choose to induce effort:
    - If one of the teams chooses to induce effort, while the two other shirk, the payoffs will differ.
    - The team that induce effort gets one, but regret its action. The increased gain of two from the common pot by inducing effort is not enough to justify the corresponding cost of three. The team would wish that it had chosen to shirk like the others and thereby obtained a payoff of zero, rather than minus one.
    - The team that shirks and is taken in control gets minus one, due to the cost of being busted in the inspection. By inducing effort, it would still have had a cost of three; now for inducing effort rather than being caught. Yet, the team's income from the common pot would have increased, such that the total payoff would have increased from minus one to one, if it had induced effort. This team will therefore wish that it had acted differently.

(*Continues on next page*)

Nonprofit Incentive Structure: Game of Internal Control

- Solving the model (*continues*):
  - If one of the teams choose to induce effort (*continues*):
    - The only team which does not regret its action will be the team that shirks and get away with it. This team will have no costs whatsoever. Thus, its payoff will be equal to the income from the common pot, which is two.
    - Since two teams would want to change their action under these circumstances, the symmetric equivalent action sets; $\{E_A, S_B, S_C\}$, $\{S_A, E_B, S_C\}$ and $\{S_A, S_B, E_C\}$; cannot be Nash equilibriums.
  - If two of the teams choose to induce effort:
    - Every team will obtain equal payoffs of one with a gross income of four from the common pot. The hard-working teams will be paying a cost of three for inducing efforts, while the shirking team faces a penalty of three, after being busted in the inspection.

(*Continues on next page*)

Nonprofit Incentive Structure: Game of Internal Control

- Solving the model (*continues*):
  - If two of the teams choose to induce effort:
    - The hard-working team, that the shirking team was suppose to inspect, would regret that it did not shirk as well. From this team's point of view, shirking would indeed decrease the income from the common pot from four to two, but it would escape from the cost of inducing effort of three and not be caught for shirking. Hence, a change of action from inducing effort to shirking would imply a increase in the team's payoff from one to two.
    - The hard-working team, which is inspected, will not regret its action. If this team had chosen to shirk instead of inducing effort, it would still have had a cost of three; now deriving from being caught in control, rather than inducing effort. However, the team would have gotten less income from the common pot; two instead of four; decreasing the total payoff from one to minus one.

    (*Continues on next page*)

Nonprofit Incentive Structure: Game of Internal Control

- Solving the model (*continues*):
  - If two of the teams choose to induce effort (*continues*):
    - The busted team will wish it had induced effort. Still, it would have had to pay a cost of three; now for inducing effort, rather than being busted in inspection. Yet, the income from the common pot would have been six, rather than four. A change of action would have increased the teams payoff from
    - Once again, two out of three teams would want to change their actions. It follows that the three symmetric equal set of actions; $\{\mathrm{E}_A, \mathrm{E}_B, \mathrm{S}_C\}$, $\{\mathrm{E}_A, \mathrm{S}_B, \mathrm{E}_C\}$ and $\{\mathrm{S}_A, \mathrm{E}_B, \mathrm{E}_C\}$; cannot be Nash equilibriums.

(*Continues on next page*)

Nonprofit Incentive Structure: Game of Internal Control

- Solving the model (*continues*):
  - If all teams choose to induce effort:
    - In this case the common pot is at its maximum level, and the fraction for each team will amount to six. Every team will pay three for inducing effort, resulting in individual payoffs of three.
    - If a team had chosen to shirk instead, it would still have had a cost of three; now for being caught during the inspection. Nevertheless, the team's income from the common pot would have decreased from six to four, implying a decline in the payoff from three to one. Clearly, such change of action is not desirable for any of the teams, implying that action set where all the teams induces effort; $\{\mathrm{E}_A, \mathrm{E}_B, \mathrm{E}_C\}$; indeed is a Nash equilibrium.
    - $\{\mathrm{E}_A, \mathrm{E}_B, \mathrm{E}_C\}$ is also the action set that yields the highest payoff for all the players separately and obviously also combined. This Nash equilibrium is therefore Pareto optimal, and a movement from any of the other action set to this one would entail a Pareto improvement.

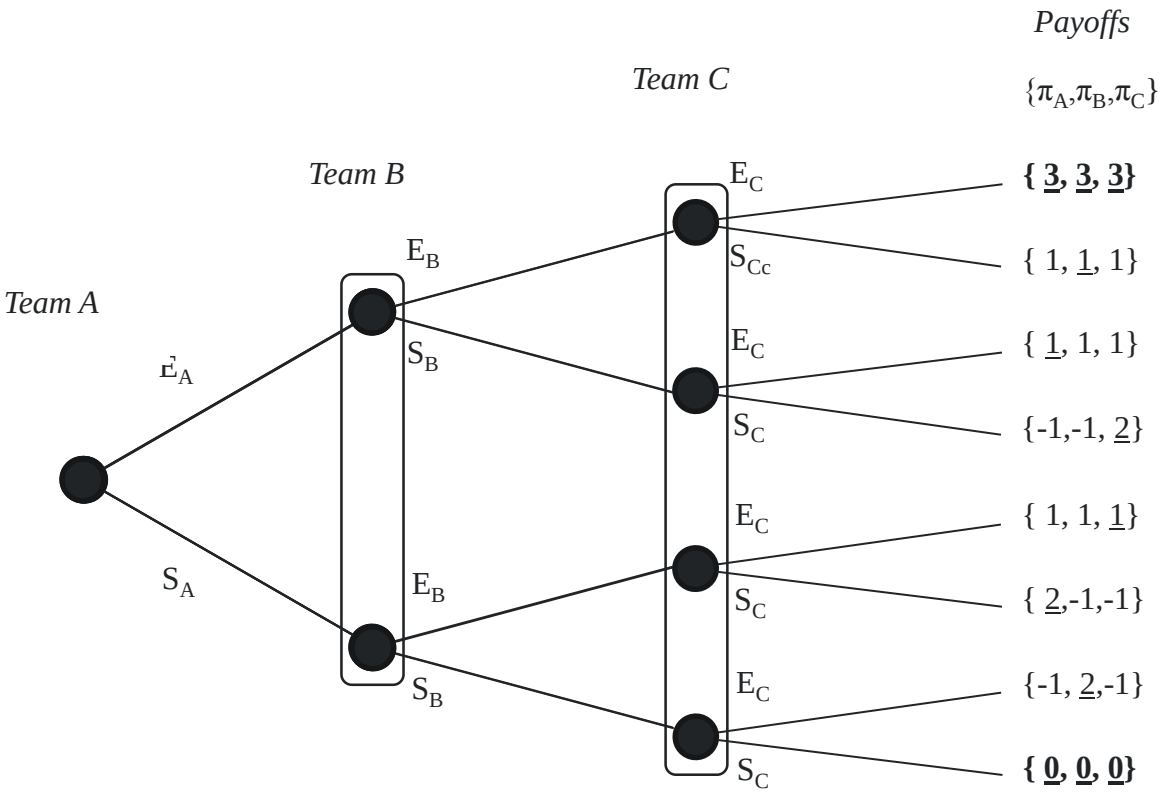
Nonprofit Incentive Structure: Game of Internal Control

C	Effort (E_C)		Shirk (S_C)	
A \ B	Effort (E_B)	Shirk (S_B)	Effort (E_B)	Shirk (S_B)
Effort (E_A)	**3, 3, 3**	1, 1, 1	1, 1, 1	-1, -1, 2
Shirk (S_A)	1, 1, 1	-1 , 2, -1	2, -1, -1	**0, 0, 0**

Normal form: Each player's desired action given the other action is underlined. The game's Nash equilibriums are marked by bold writing.

MENON Business Economics

Nonprofit Incentive Structure: Game of Internal Control



Extensive form: The preferred actions given the other strategies are marked by underlying and the Nash equilibriums are marked by bold. Dots mark the actions nodes, whereas the circular lines imply that the actor in question cannot distinguish between the different situations, since the game is simultaneous.

Nonprofit Incentive Structure: Game of Internal Control

- Learning outcomes:
  - The game is a Pareto coordination game with three players, where the social aim should be to achieve the Pareto optimal Nash equilibrium.
  - The rationale behind the game will is how interior control mechanisms may or may not discipline the management in lack of a principal.
  - If a nonprofit is in a good state, it is likely to stay there.
  - If a nonprofit is in a bad state, it can be hard to get out.
  - Small nonprofits in the good state are relatively vulnerable to shocks. On the other hand, it is for smaller to nonprofits
  - The Nash equilibriums in large nonprofits are likely to be more stable. Since the large nonprofit have grown large, they are likely to be in the good state in the first place.

Nonprofit Incentive Structure: Game of Internal Control

- Possible extensions:
  - If one team is a purely altruistic actor who always induces effort, the Pareto optimal equilibrium will be the only Nash equilibrium.
  - If communication is possible, no team will have incentive to deviate from the Pareto optimal Nash equilibrium, knowing it will be caught.
  - The Pareto optimal Nash equilibrium is likely to act as a focal point both in a static and a dynamic setting.
  - Non-monetary factors could easily be included in the payoffs (e.g. altruism, social sanctions, reputation and legal procession).
  - All mixed strategies are likely to be unstable and can be neglected. Separation of control and inspection may imply that more stable Nash equilibriums could exist, and thereby impede Pareto coordination.
  - In a dynamic setting, the Pareto Nash equilibrium becomes the only Sub-Game Perfect Nash equilibrium. The Pareto Optimal Nash equilibrium becomes easier to implement through access to historical observability and punishment strategies.

Nonprofit Incentive Structure: Behavioral Factors

- The conventional behavioral hypothesis within economic theory is the *Homo Economicus hypothesis* (i.e. the individuals are rational egoists who maximize their own utility based on external motivational factors).
- In this framework, inducing effort is associated with a perceived cost of shirking, whereas intrinsic motivation factors are typically neglected.
- Traditional economic theory is occasionally criticized by behavioral economists and professionals from other branches of research for not taking behavioral factors, such as internal motivational factors care for other utility gains, in to account.
- Behavioral factors that affect the way people acts will of course have an impact on how organizations function. From my point of view, they are likely to be one of the very main reasons for why many nonprofits function so well, counteracting predictions about dominating moral hazard and rent-seeking.

Nonprofit Incentive Structure: Behavioral Factors

- Motivation:
  - Motivation is defined as the biological, psychological and social factors, that actives and provides direction for organizations and maintain behaviors to various degree of intensity in relation to the achievement of objectives.
  - The source of external motivation lies outside the work activity itself, typically in terms of a wage incentive structure. In context of economic incentives, external motivation primarily promotes quantitative performance, seeing that high qualitative performance is hard to observe and verify.
  - In the case of intrinsic motivation, on the other hand, the motivational source lies within the execution of the work itself. Such motivation typically stems from needs for competence development, perceived influence on the process and recognition for good work.

(*Continues on next page*)

Nonprofit Incentive Structure: Behavioral Factors

- Motivation (*continues*)*:*
  - Nonprofits tend to combine monetary rewards and other rewards, where the monetary component is of smaller magnitude than for forprofits and public firms (Bacchiega and Borzaga 2003).
  - In general, the empirical research suggests that intrinsic motivation make the nonprofits more armed to oppose opportunistic behavior, than forprofits and public enterprises (Bacchiega and Borzaga 2003).
  - Nonprofits' ability to develop and utilize intrinsic motivation enables nonprofits to mobilize more resources, and thereby ensure their own survival (Valentinov 2007).
  - More generally, some workers might be inclined to accept a lower wage in order to work for an organization, which objective largely coincides with their personal believes (confer the section about green workers).

Nonprofit Incentive Structure: Behavioral Factors

- Organizational culture:
  - Organizational culture is an intersubjective pattern of assumptions for, and interpretations of, learning and problem solving; both inside the organization and in the surroundings; shared by the members of the organization (Jacobsen and Thorsvik 2002).
  - The social dimension in nonprofits is as an important factor in providing a productive organizational culture with favorable incentive structure. More concrete, explicit social objective enable workers to measure their performance, involvement of beneficiaries could create reciprocal trust relations, and democratic management make the workers feel appreciated (Bacchiega and Borzaga 2003).
  - If the inner actors of nonprofits care about each other and observe each other, they could apply social pressure on shirkers and endorse codes of behavior that promote the group's common interests (Ben-Ner and Gui 2003).
  - Unclear formulation of aims could be result in interior conflicts (Badelt 2003).

Nonprofit Incentive Structure: Behavioral Factors

- Job satisfaction:
  - Job satisfaction could be viewed both as a positive attitude and a positive emotion related to own work. It depends on the interaction between expectations, needs and values on the one hand, and the job situation's implications and possibilities on the other hand.
  - The direct correlation between job satisfaction and job performance is about thirty percent. This correlation was increasing in the complexity of the work exercises (Kaufmann and Kaufmann 1996).
  - Nonprofit employees are generally more satisfied with their work than forprofit and public employees (Bacchiega and Borzaga 2003).
  - Job satisfaction is driven by intrinsic motivation and relational work attitudes, whereas workers motivated by monetary gain tend to be less satisfied (Borzaga and Tortina 2006).
  - Moreover, nonprofits' employees tend to be satisfied with their job due to an incentive mix of worker involvement and other processes related of the job (ibid.).

Nonprofit Incentive Structure: Behavioral Factors

- Organizational commitment:
  - Organizational commitment is defined as an attitude that reflects the strength of the individual's identification with, and involvement in, the organization he works for.
  - The main reason for stimulating employees' organizational commitment is to increase the organizational performance directly, by making them induce a higher level of effort.
  - Besides, organizational commitment is likely to enforce organizational performance indirectly, for instance by reducing the turnover rate and increase job satisfaction.
  - Nonprofit workers are less inclined to change employer, due to higher job satisfaction (Bacchiega and Borzaga 2003).
  - In the Italian social service sector, a large majority of the workers in social cooperatives and other associations choose their jobs, because of the contents (ibid.).

Nonprofit Incentive Structure: Behavioral Factors

- Transformational management:
  - Neoclassic economic theory builds on ‘transactional management’ based on exchange of values (e.g. work for money) and self-interests. Transactional management motivates through external factors
  - The management literature embraces another sort of management as more effective in motivating workers; namely ‘transformational management’. Transformational management is directed to inspire employees to commitment and engagement to the organization’s mission by highlighting intrinsic motivation.
  - Nonprofit leaders are particularly committed to keep their organization's mission alive (Bhatnagar and Nair 2011) and often rather innovative (Bacchiega and Borzaga 2003).
  - When contractual relations are loosely defined, the democratic and open management of nonprofits plays an important role in redirecting strategies, provide wage structure that are perceived fair and engage workers, such that the both strategies and organizational behavior are in line with the organizational objective (ibid.).

Nonprofit Incentive Structure: Green Worker Theory

- Corporate social responsibility (CSR) can improve firms' ability to recruit highly motivated employees under unobservable effort, if they in addition to wage, care about corporate responsibility.
- Green worker theory distinguishes between…:
  - … firms that are committed to CSR (i.e. green firms) and firms that are not (i.e. brown firms).
  - … idealistic workers that care about CSR and shirk little (i.e. green workers) and selfish workers that do not care about CSR and shirk more often (i.e. brown workers).
- Green firms may be able to use screening devices for self-selection, and thereby obtain a competitive advantage.
- This remains the case even when the green workers willingness to pay for green employment is rather limited and their numbers are low.
- Voluntary workers could be considered as an extreme version of green workers.

Nonprofit Incentive Structure: Green Worker Theory

- I argue that the missing link between green worker theory and the nonprofit theory is the perception of the nonprofit institutional form, social aims and lack of profit incentives as possible signals for corporate social responsibility to green workers and volunteers.
- If nonprofits appear more credible as a social responsible employer than forprofits, the theory could help explaining how nonprofits, which are not wage-leading, could attract highly qualified workers.
- In an environment with asymmetric information and pressure for quantitative performance, nonprofits are likely to be less reliant on monitoring of the workers' effort levels than forprofits. Thus, they are often better equipped to prioritize of advanced and complex tasks.
- Frank (2009) argues that altruistic motivation could be captured by considering wage as a function of a public good, where the worker in question is willing to give up some of his wage for more public goods.
- I have shown how this feature could be integrated formally into the nonprofit framework in the section about the public good approach (Holmen 2012).

Nonprofit Incentive Structure: Green Worker Theory

- The nonprofit institutional form seem to enable nonprofits to generate an incentive scheme for managers and workers, which is consistent with the organizations' objectives (Bacchiega and Borzaga 2003).
- In contrary to theoretical predictions of moral hazard premiums, professional workers tend to have lower wages in nonprofit firms (Bacchiega and Borzaga 2003, Steinberg 2003).
- There is plenty of empirical evidence for nonprofits making more use of volunteer labor, than any other forms of institutions (Badelt 2003).
- Voluntary contributions decreases the wage level of paid employees in the nonprofit sector (Bacchiega and Borzaga 2003).
- There tend to be wage compression between the public enterprises and nonprofits, which acts in the same sector over time (ibid.)
- The Norwegian business foundation, Det Norske Veritas (DNV), has some fringe goods beyond the ordinary fringe benefits, such as an extra week of holiday and support of environmental initiatives. Yet, DNV is not wage-leading (DNV and VEFF 2010, Holmen 2012).

Nonprofit Incentive Structure: Stewardship and Principal-Agent Theory Combined

- Principal-agent theory highlight the moral hazard problems and the interest conflict between the principal and the agent.
- Stewardship theory focuses on the common interests of the two parties and intrinsic motivation.
- I believe a combination of these approaches would have been a great theoretical break-through. In recent literature, Belgian authors (e.g. Caers et al. 2006 and Caers et al. 2011) have proposed a unification of principal-agent theory and stewardship theory.
- The unified theory could be applied both on the relationship between the stakeholders and the management, and the relationship between the management and the workers.
- What is more, the unifies theory could be combined with the stakeholder approach, analyzing how various stakeholders may act as multiple principals.

Content

- Introduction
- Categorization of Organizations in the Business Sector
- The Nonprofit Landscape
- Theory of Demand for Nonprofits
- Theory of Supply for Nonprofits
- Nonprofit Incentive Structure
- Financing of Nonprofits
- Conclusion

Financing of Nonprofits: Sources of Finance

- Private support:
  - Despite of game-theoretical predictions of free-rider problem, people do to a large extent involve themselves in charity.
  - A donation is made, because the donor prefers it over non-donation (e.g. altruism, social glow, sponsor benefits or social pressure).
  - Private support includes bequest, gifts and labor donations.
  - People tend to be more inclined to give donations or volunteer for nonprofits than forprofit, due to the nonprofits' lack of profit incentives.
  - Charity donations could be considered as an expression for heterogeneous preferences in the distribution policy with a critical amount of people dissatisfied with the prevailing public policies.
  - A high tax level reduces the relative cost of volunteering, but increases the alternative value of charitable donations. Studies shows that the former effect usually dominates in the short run, whereas it unclear whether there are any long term effects.

Financing of Nonprofits: Sources of Finance

- Public support:
  - Public support to nonprofits includes direct grants, tax exemptions and assignments of valuable contracts.
  - Compared to public enterprises, nonprofits are less bureaucratic and often to a larger extend disciplined by firm's efficiency indicators.
  - Nonprofits provide a way for the public sector to finance political sensitive, but yet socially beneficial, goods and services.
  - Crowding in effects often dominate for small government contribution, whereas the crowding out effects typically come to dominate for modest and more extensive public financing.

Financing of Nonprofits: Sources of Finance

- Fees:
  - Nearly fifty percent of the total financing of nonprofits with a element of voluntary contribution stems from fees and sales (Anheier 2003).
  - Member fees are particularly important in clubs and consumer cooperatives.
  - User-fees a ‘two-edged’ sword, in the sense that the target group could be crowded out, when the good in question is user-fee financed.
  - The crowding out problem could be solved by price discrimination, where target groups with low solvency are offered lower prices.

Financing of Nonprofits: Sources of Finance

- Sales:
  - Sales constitute the far most vital source of finance for nonprofit firms in the business sector and is also important for many other sorts of nonprofits.
  - Commercial activities tends to suppress private donations (Kingma 1995, 1996, confer Steinberg 2003)
  - Nonprofits tend to engage in commercial partnership with private firms, when the income from private and public donations are low compared to the operative ambitions.

Financing of Nonprofits: The Financial Rigidity Challenge

- Up to recently, the financial rigidity challenge has been one of the most neglected fields in the study of nonprofits.
- Financial rigidity provides a challenge for foundations' evolution:
  - Foundations cannot easily adjust their equity. Inefficient debt ratio will in turn impede the growth rate of the nonprofit sector.
  - The 'hostile take-over mechanism' is not available for nonprofits as a disciplining threat, in absence of privately held stocks.
- Associations face similar problems as foundations. Cooperatives and mutuals is to some extent relax, seeing that they can pay out dividends.
- Recent developments:
  - In Bowmann's (2011) model, nonprofits must first overcome capacity issues through resiliency in the short run, and then sustainability through maintenance services in the long run.
  - In Jegers' (2011) model, the difficulties in ensuring new equity constitute an additional capital restraint, which are dependent on income prospects and not creditworthiness.

Financing of Nonprofits: The Financial Rigidity Challenge

- Evaluation from an equity return stand (Holmen 2012):
  - By emission and dividends, the corporation's return on equity, adjusted for the risk level, are expected to be equal the market return on equity in the long run.
  - If on the one hand, a corporation is run optimally given its equity level, and the corporation's return on equity is lower than required in the market for a given risk level, it can sell its least productive assets and give out dividends.
  - If on the other hand, the corporation's return on equity is above the market requirement, it can finance its unrealized beneficial projects by running an emission or by equity injections from the owners.
  - Hence, the corporation's return on equity, adjusted for the risk level, is expected to be equal the market return on equity in the long run.
  - A foundation does not have the same financial flexibility, which could give it a competitive disadvantage.

(*Continues on next page*)

Financing of Nonprofits: The Financial Rigidity Challenge

- Evaluation from an equity return stand (*continues*):
  - In a competitive market with full information, nonprofits' financial rigidity does not have to imply a significant social loss from a social planner's point of view.
  - If the nonprofit is unable to make use of a profitable business opportunity, some other firm will realize this and take advantage of the arbitrage opportunity.
  - If the foundation is unable to get rid of unproductive equity capital, it will loose it in time. In the process, other firms could be affected negatively by an overinvestment in the industry in question.
  - However, if the foundation possesses some sort of competitive advantages like for instance economic of scale and scoop or possibly peculiar assets and competence, the financial rigidity of foundations could become a lasting social problem as well.

Financing of Nonprofits: The Financial Rigidity Challenge

- Equity adjustment mechanisms for foundations (Holmen 2012):
  - Expansion measures:
    - One possible way to expand foundations' activities is to create a holding company, secure control and run an emission.
    - Fund-raising could be a solution, if the foundation has sufficient back-up in the society.
    - One could hire external consultancy, given that this is cheaper
  - Austerity measures:
    - If there exist a holding company, the foundation could pay out dividends and buy a larger owner share.
    - The foundation could engage in another industry with a higher rate of return, if the business projects were not evaluated initially.
    - A charity back-up could be utilized to decrease their activities, when their business prospects are slim. Nonetheless, the founding document is likely to put limitations on such applications.

Content

- Introduction
- Categorization of Organizations in the Business Sector
- The Nonprofit Landscape
- Theory of Demand for Nonprofits
- Theory of Supply for Nonprofits
- Nonprofit Incentive Structure
- Financing of Nonprofits
- Conclusion

Conclusion:
Contributions to the Literature

- In my thesis and in this presentation, I have gathered, reviewed and evaluated the existing nonprofit theory.
- My main original contributions to the literature are:
  - Predictions about future trends for the nonprofit sector
  - Comparative analysis of both internal and external crowding out effects in a nonprofit's public good provision
  - Integration of green worker theory to the nonprofit theory, both informal theory and formal modeling
  - Sketch integration of green consumer theory
  - Develop my own game of internal control to highpoint nonprofits' control mechanisms
  - Mapping nonprofits' financial adjustment mechanisms and attack the financial rigidity from a equity return stand

Conclusion:
Main Findings

- Nonprofits might be the best response to governing and market failures, both on the demand side and the supply side.
- Moreover, nonprofits seem to achieve comparative advantages contra the forprofits and the public enterprises under certain circumstances, by their combination of inability to distribute profits, political autonomy and social aims; and for some nonprofit organizational designs; their leeway for stakeholder control.
- Overall, the third sector is limited by lack of financing from donors, lack of entrepreneurs, financial rigidity, moral hazard, rent-seeking and less professional organizations.
- These features may inter alia enable nonprofits to attract green workers, provide public goods that cut across political priorities and achieve more trustworthiness in the provision of unverifiable goods.