

Chapter 1

The Theory of Nonprofit Organizations Revisited

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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);

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