

Vladislav Valentinov

## Some reflections on the transaction cost theory of nonprofit organisation

*Bounded rationality; nonprofit organisation; opportunism; transaction costs*

*The paper extends the transaction cost theory of nonprofit organisation by differentiating between two types of transaction costs that are reduced by nonprofits: opportunism-induced, which have been emphasised by existing transaction cost approaches, and bounded rationality-induced, which are conditioned by shortages of information and limited information-processing abilities of individuals who can contribute resources to nonprofits. By reducing these costs, nonprofits increase the total amount of resources that can be contributed to them. The significance of bounded rationality-induced transaction costs is confirmed by the fact that they often appear to be economised by nonprofits more efficiently than opportunism-induced transaction costs.*

### I. Introduction

The economic theory of nonprofit organisation has experienced significant progress in recent decades. Particularly, the existence of nonprofit firms has come to be attributed to a number of specific market and government failures which highlight the need for alternative institutional frameworks for performing socially useful tasks. A possible way of conceptualising these failures lies in demonstrating the superior transaction cost economising attributes of nonprofit organisation in comparison to for-profit firms and governmental agencies. This represents the main thrust of available transaction cost explanations of nonprofit organisation.<sup>1</sup> Whereas utilising transaction cost theory to explain the existence of nonprofit firms offers an interesting perspective on the nature of these organisations, such explanations have been criticised on a number of grounds, one of which relates to the relevance of the behavioural assumptions of transaction cost economics (particularly opportunism) to the operation of organisations which might owe their very existence to the presence of trust and shared social values.<sup>2</sup> Indeed, the existence of some nonprofits, especially of those which use private funds to pursue public purposes, represents an inexplicable paradox if one assumes people to be rational utility maximisers behaving opportunistically at every turn.<sup>3</sup> Rather, as noted by Rose-Ackerman,<sup>4</sup> the true understanding of nonprofit organisation "requires a richer conception of individual utility functions and a base in cognitive psychology that incorporates the power of ideas and

1 See Krashinsky (1986); Theuvsen (1999).

2 See Theuvsen (1999), p. 238.

3 See Williamson (1996), p. 56 f.

4 Rose-Ackerman (1996), p. 701.

emotions in motivating behaviour". Moreover, the transaction cost approach emphasises the cost side of governance structures and thereby tends to ignore benefits that might not be easily measurable. A more fundamental criticism is that transaction cost analyses of nonprofit organisation generate little "value added" compared to other theoretical explanations such as contract failure theory,<sup>5</sup> public goods theory,<sup>6</sup> and consumer control theory.<sup>7</sup> Indeed, transaction cost analyses appear to be reformulations of other theories in terms of "economising on transaction costs" rather than independent contributions offering ideas which have not been advanced, if in a somewhat different form, within alternative theoretical approaches.<sup>8</sup>

Despite these criticisms, this paper will seek to defend the usefulness of transaction cost approaches to nonprofit organisation and identify additional transaction cost advantages of nonprofits beyond those which represent mere reformulations of alternative theoretical approaches. This will be achieved by adopting a new perspective on the behavioural assumptions of transaction cost theory – a perspective that views transaction costs as an outcome mainly of bounded rationality rather than of opportunism. Whereas transaction cost theory attaches equal importance to both of these behavioural assumptions, this paper will draw a distinction between transaction costs which are caused mainly by opportunism and those caused mainly by bounded rationality. Although in many cases it is the interaction of these two behavioural factors that matters, it will be shown that in the special case of nonprofit organisation, the differentiation between them can generate insights into the ways in which this organisation economises on transaction costs. By adopting this argumentation, the paper will be able to address the mentioned criticisms of transaction cost theories of nonprofit organisation. Yet this defence of the transaction cost approach is not intended to illustrate that the economic nature of nonprofit organisation can be fully explained in terms of mere transaction cost-economising logic. Indeed, transaction cost reasoning relies on a number of restrictive assumptions which do constrain its heuristic power. This paper will not seek to defend these assumptions but rather to make the best use of them in developing a theoretical explanation of the existence of nonprofit organisation. The paper is organised as follows. Section 2 reviews the major transaction cost explanations of nonprofit organisation; Section 3 proposes an extension of these explanations by differentiating between opportunism-induced and bounded rationality-induced transaction costs; Section 4 discusses whether one of these types of transaction costs can be more important than the other for the actual operation of nonprofits; Section 5 contains concluding remarks.

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5 See Hansmann (1980).

6 See Weisbrod (1977).

7 See Ben-Ner (1986).

8 See Theuvsen (1999), p. 229.

## II. Transaction cost explanations of nonprofit organisation

Krashinsky<sup>9</sup> argues that three types of transaction costs are relevant for the operation of an economy: 1) costs between producers; 2) costs between producers and consumers; 3) costs between consumers. Whereas the costs of the first type are perceived as "normal" and can be reduced by vertical integration, the costs of other two types are "unusual" in that they require different cost-economising institutions, represented by nonprofit organisation. Transaction costs between producers and consumers emerge due to the existence of trust goods, the quality of which cannot be easily established by consumers; transaction costs between consumers are explained by the existence of collective (or public) goods whose consumption is characterised by low rivalry and/or low excludability.

The provision of trust goods by for-profit firms is problematic because for-profit entrepreneurs would have incentives to downgrade quality/quantity characteristics of goods offered at any given price, and then appropriate the resulting profits. A possible consumer response could be to monitor a producer's production process; such monitoring, however, is associated with significant transaction costs. However, the provision of trust goods by a nonprofit firm would allow these costs to be avoided, since nonprofit firms cannot distribute their earnings to patrons or members, and therefore have no incentive to cheat consumers. In this sense, nonprofit firms are more trustworthy than for-profit ones.<sup>10</sup>

Krashinsky<sup>11</sup> emphasises that nonprofit organisation represents just one institution devised to address the problem of trust goods. Other possible institutions include e.g. the development of professional practices, public regulation, warranties, liability laws, insurance against liability, reputation, franchising, and department stores. Whereas all of the aforementioned institutions reduce transaction costs which accompany the provision of trust goods, nonprofit organisation exhibits superior transaction cost economising attributes where there is a separation between the purchaser and the direct beneficiary of the goods. Two types of this separation are most realistic: 1) individuals make donations for charitable purposes, i.e., for the benefit of third parties who do not communicate directly with the donors; 2) some family members purchase services for other members, such as small children or elderly people who cannot evaluate the quality of the services or cannot communicate their opinion to the purchaser.

Jointness of consumption is another attribute of goods which makes for-profit firms inappropriate for the organisation of their supply. Jointness of consumption, in its extreme form characteristic of public goods, presupposes that individuals can benefit from consumption without having to pay for it. This naturally generates incentives for free-riding and causes the undersupply of such goods by for-profit firms. A possible solution is to delegate the production of these goods to the state, which can solve the free-riding prob-

<sup>9</sup> See Krashinsky (1986).

<sup>10</sup> A possible objection to this argument is that the opportunistic behaviour of for-profit firms would be forthcoming mainly in the case of monopoly/duopoly, but not when competition among these firms is sufficiently strong. Yet a closer analysis would reveal that when the true costs of production are not observable, the presence of competition might constrain but not fully eliminate this opportunistic behaviour.

<sup>11</sup> Ibid.

lem by imposing compulsory taxes. However, government provides public goods to meet the needs of the median voter. If a fragment of the population happens to have a greater need for a certain good than does the median voter, then nonprofit organisation represents a mechanism to satisfy this residual demand through the private production of public goods by those who have a greater need for these goods.<sup>12</sup> The transaction cost economising role of such nonprofits is twofold: 1) it is less costly for consumers to organise a nonprofit organisation than it is to lobby government officials to change the rules of political decision-making, or to alter the structure of the taxation system<sup>13</sup>; and 2) nonprofits allow free-riding problems to be overcome by reducing the costs of negotiation among consumers by gathering consumers together in organisations which emphasise community and responsibility.<sup>14</sup>

The possibility of private contributions to the production of public goods is thereby given a twofold explanation: the interdependence of utility functions and the existence of "warm-glow effects" resulting from charitable giving. The first explanation posits that the utility levels of some individuals depend on the utility levels of other individuals, with various degrees of specification of the ways in which the latter individuals use the donated funds to increase their utility.<sup>15</sup> According to the second explanation, the act of giving may create for the donors "warm-glow effects" such as pride, prestige, career advancement, and expectations of respect and recognition.<sup>16</sup> The existence of these "warm-glow" effects attenuates the problem of free-riding that is sometimes characteristic of interdependent utility functions.

The contract failure and public goods theories of nonprofit organisation are complementary in that the first theory explains why for-profit firms are less likely to be entrusted with contracts for delivery of public goods: since for-profit firms can distribute donations as profits, they will have incentives to "cut corners on quality"<sup>17</sup>. The nondistribution constraint characteristic for nonprofit firms again operates as a signal of their trustworthiness for individual donors.

Thus, both outlined transaction cost approaches illustrate how nonprofit organisation is equipped to deal with transaction costs generated by the danger of opportunistic behaviour (given the condition of bounded rationality). In the case of trust goods, the relevant opportunistic behaviour is that of producers selling products of deliberately reduced quality; but in the case of public goods, nonprofit organisation serves to prevent free-riding by consumers who need those goods by improving the structure of stakeholders' incentives. Although these transaction cost approaches disclose relevant determinants of the existence of nonprofit organisation, one can nevertheless question whether they really

12 This reasoning implies that in some cases the goods and services produced by nonprofit firms simultaneously have the attributes of private and public goods for different stakeholders. For example, the benefits that the poor derive from receiving specific social and welfare services may take the form of private goods; yet the alleviation of the condition of the poor which is achieved thereby represents a public good for the society in general.

13 See Theuvsen (1999), p. 228.

14 See Krashinsky (1986).

15 See e.g. Collard (1978); Becker (1974).

16 See Rose-Ackerman (1996), p. 713 f; see also Andreoni (1989, 1990).

17 Ibid.

provide a full account of the whole spectrum of transaction costs economised by this institutional arrangement.

Specifically, it can be argued that transaction costs discussed in these approaches would not exist in the absence of opportunistic behaviour. At the same time, the rationale for many nonprofits, particularly for those that may be called "public benefit" nonprofits, is represented by the desire of individuals to pursue certain social values that can be understood as general or abstract views about better organisation of social reality. The pursuance of social values in many cases can be and is realised by charitable donations of financial resources or time (in the case of volunteering). Even though in some cases this giving may not reflect underlying altruistic motives, but rather be guided by a moral value of reciprocity or the prospect of receiving private benefits such as prestige, pride, and invitations to elite parties<sup>18</sup>, it is still questionable whether it makes sense to speak about opportunistic motives for donating. Indeed, in the worst case, donating can be motivated by purely egoistic reasons, but definitely not opportunistic.

The irrelevance of opportunism in charitable giving, however, gives rise to an interesting question: given that opportunism is a source of transaction costs, does it mean that charitable giving occurs without them? Or, in other words, if we assume that donors have equal trust in for-profit and nonprofit firms regarding the adequate use of contributed funds, does that mean that nonprofits will become redundant, especially given their possible incentive inefficiencies? Or, in the case of nonprofits producing public goods, if we assume that all individuals needing those goods have fully internalised the incentives to pay for them and therefore do not require to be ideologically affected to do so, does that mean that such nonprofits no longer have transaction costs on which they economise?<sup>19</sup>

As will be shown below, all of these questions can be answered negatively. The idea suggested by them is that in the case of nonprofit organisation, it makes sense to distinguish between two types of transaction costs. One type, which is well-captured by the aforementioned transaction cost approaches, can be designated "opportunism-induced", indicating that their essential factor is the danger of opportunistic behaviour. The second type of transaction costs can be called "bounded rationality-induced" to show that they are conditioned by shortages of information and the limited information-processing abilities of individuals rather than by prospects of opportunistic behaviour. The term "opportunism-induced transaction costs" is inexact because these costs represent the genuine effect of interaction between the behavioural conditions of opportunism and bounded rationality. It will be used, however, to indicate the contrast between the two types of these costs: opportunism is relevant for one but not the other. The distinction between these types of costs extends the transaction cost rationalisation of nonprofit organisation, which is undertaken in the next section.

<sup>18</sup> See Rose-Ackermann (1996), p. 714.

<sup>19</sup> This question also reflects certain incompleteness of transaction cost explanation of nonprofits producing public goods. Whereas, according to this explanation, nonprofits reduce transaction costs of free-riding, it is evident that even if free-riding were absent, such nonprofits would anyway have to exist in order to carry out the production of these goods. Therefore, although economising on these transaction costs represents an important function of such nonprofits, it is insufficient to explain their existence.

### III. Extending the transaction cost view of nonprofit organisation

The core argument of this paper is that the transaction cost view of nonprofit organisation can be deepened by considering the effects not only of opportunism-induced transaction costs, as is done by existing approaches, but also those effects of bounded rationality-induced costs. In a general case, the existence of these costs suggests that whereas individuals may feel the desire to contribute resources towards a certain cause, they have to know who the most relevant beneficiary of these contributions is and how the use of the contributed resources can be organised effectively and efficiently. Indeed, to take the case of charitable giving, the increase in the number of individuals who are in need will not only strengthen the motivation of potential donors to contribute resources, but also, paradoxically, complicate the decision for each donor regarding the most efficient and effective use of his contribution. The number of individuals in need thus appears to be not only a factor of social relevance of donating but also of uncertainty regarding its best organisation. Charitable giving is therefore associated with information costs, designated here as "bounded rationality-induced" transaction costs.

Moreover, information costs are relevant not only in the context of nonprofit activities involving voluntary contributions of resources, both for explicitly charitable purposes and organisation of mutual services. According to contract failure theory, nonprofit organisation is optimal for the provision of trust goods because it dampens incentives to downgrade their quality. On the other hand, apart from opportunism considerations, one can question whether producers of these goods are able to effectively perceive and keep track of the consumer preferences regarding their desired configuration or composition. It can be supposed that for some goods, price signals do not provide producers with sufficient information regarding what kind of good is most desired by consumers; this may be particularly true with goods whose quality cannot be directly observed.

Drawing on Ben-Ner's customer control theory, nonprofit organisation in this case can economise on information costs by providing consumers with decision-making powers regarding the organisation of production and supply of such goods. Specifically, nonprofits allow both producers and consumers to avoid incurring high costs of communication through the market by giving consumers an opportunity to exercise direct control over production and supply. Hansmann's and Ben-Ner's theories thus appear complementary: whereas the former can be rationalised as dealing with "opportunism-induced" transaction costs, the latter deals with "bounded rationality-induced" transaction costs. However, this application of the concept of "bounded rationality-induced" costs, though logically consistent with the available theoretical contributions, can be criticised on the grounds that it merely represents their reformulation in transaction cost terms rather than a conceptual extension generating new insights.

Yet the situation appears different with those nonprofits which presuppose the voluntary contribution of resources. These nonprofits can be classified into two ideal theoretical types: mutual benefit (offering services for their members) and public benefit (using private funds to pursue public purposes). Whereas public benefit nonprofits are explicitly

charitable (since donors and beneficiaries are not the same) mutual benefit nonprofits cannot be regarded as charitable in this sense. Nevertheless, given the possibility of the free-rider problem in the production of public goods, the voluntary contribution of resources, even to mutual benefit nonprofits, still requires that patrons be motivated not only by myopic egoistic considerations. Since they represent ideal types, many real-world nonprofits exhibit a combination of their transaction cost economising features.<sup>20</sup> The following subsections will describe these features in more detail.

## 1. Public benefit nonprofits

The standard transaction cost view of public benefit nonprofits argues that thanks to their nondistribution constraint they help reduce the transaction costs of monitoring the use of contributed funds in comparison to the costs that would be incurred when contributing to for-profit firms. The transaction cost-economising effect occurs precisely due to the higher trustworthiness of nonprofits compared to for-profit firms. In order to demonstrate that the "opportunism-induced" transaction costs economised in this way are not the only relevant transaction costs, let us assume that potential donors have equal trust in the two types of firms.<sup>21</sup> With equal trust, the presence of a nondistribution constraint will be an insufficient reason for donors to prefer dealing with nonprofit rather than for-profit firms. What implications, then, follow from this assumption?

In this situation, apart from the danger of for-profit firms' opportunistic behaviour, potential donors would discover that they face significantly different transaction costs when donating to the two types of firms.<sup>22</sup> When dealing with for-profit firms, they would have to make independent decisions about which individuals should be the major beneficiaries, how the production of required goods and services should be organised, and in which organisational framework form they should be supplied to the target audience. In addition, potential donors would need to undertake a search for a suitable for-profit firm, clearly formulate the nature of the task to its leadership, and conduct contract negotiations. Since for-profit firms do not normally engage in charitable activities, at least to a significant extent, and therefore have not developed respective organisational routines, potential donors may need to maintain clear and precise communication with these firms regarding the execution of the charitable activities for which they are contracted. Search-

20 This classification is based on the understanding that hard-and-fast distinctions between these two types of nonprofits can be difficult to draw. Indeed, mutual-benefit nonprofits can serve public purposes by achieving benefits which also favourably affect nonmembers. The relevant criterion for this classification, however, can be found in the nature of the main activities of nonprofits as stated in their missions. Namely, nonprofits can be attributed to these two groups depending on whether they regard delivery of services to members or the pursuance of public interest as their main activity, allowing for the possibility of indirect effects, which may blur the boundary between public- and mutual-benefit orientation.

21 This assumption seems particularly realistic in the light of studies which did not find clear evidence that nondistribution constraint alone makes organizations more trustworthy; rather, they suggest that it does not. See James (1983); James (1986); Ortmann and Schlesinger (1997).

22 This comparison is based on the understanding that for-profit firms engage in those activities which allow the generation of profit and avoid activities which do not allow it, while the main activities undertaken by public benefit nonprofits are of the latter type.

ing for suitable for-profit firms may also present difficulties since such firms advertise only their profit-oriented activities; whether or not they have adequate resources to realise the donors' intentions would not necessarily be obvious from these advertisements. Moreover, it can be difficult for a potential donor to determine whether the resources possessed by a for-profit firm correspond to the nature of the charitable task in question; even with well-informed potential donors, there may be differences of opinion with regard to whether the available resources are adequate or not.

Particularly obvious is the transaction cost-economising role of fundraising activities, which constitute an indispensable financing mechanism of public benefit nonprofits. Fundraising campaigns basically represent attempts to dramatically reduce the transaction costs of donating, assuming that individuals adhere to certain social values, the actual realisation of which can be facilitated through donations. Apart from convincing individuals to donate, fundraising campaigns aim to suggest easy (i.e., inexpensive in terms of transaction costs) ways to donate, e.g. through the internet or special phone calls. Fundraising campaigns also provide extensive information to potential donors regarding whom they can help and how can they do it, particularly if there are alternative possibilities of helping.<sup>23</sup> This information is particularly important for small donations characterised by relatively low marginal utility and high marginal costs due to high information costs (although direct costs are relatively low). For example, the appeal of donating 2 Euro each month to support specific individuals in the Third World not only persuades, but also reduces information costs. Presumably, there are a number of individuals who would be willing and able to donate 2 Euro each month; however, they would not donate this money unless they knew how it would be used, and taking into account the small size of the contribution, the costs of learning about its potential uses would very likely outweigh the expected marginal utility of donating it. The economic feasibility of this donation therefore increases when the necessary information costs are incurred by nonprofits.

To generalise, public benefit nonprofits generate and process vast amounts of information, facilitate its communication and exchange, and freely provide it to potential donors. In this way, public benefit nonprofits perform an important informational role which was recognised several decades ago in the German literature on the economic theory of nonprofit enterprises (*Gemeinwirtschaft*).<sup>24</sup> In terms of the contemporary transaction cost theory of nonprofit organisation, the informational role of public benefit nonprofits reflects the importance of economising on bounded rationality-induced transaction costs as opposed to opportunism-induced costs emphasised by the conventional transaction cost approach.

## 2. Mutual benefit nonprofits

The standard transaction cost view of mutual benefit nonprofits explains them in terms of their ability to reduce free-riding behaviour; this is achieved by strengthening trust and

23 See e.g. Strachwitz (1994).

24 See e.g. Kühne (1971); Thiemeyer (1970); Rittig (1977); Eichhorn (1974); Ritschl (1931).



adhering to social values among consumers of public goods. Trust and social values undoubtedly reduce opportunism; however, the role of bounded rationality-induced transaction costs also appear significant for nonprofits serving members rather than third-party beneficiaries.

The significance of bounded rationality-induced transaction costs is explained by the fact that different individuals have different marginal utilities from consuming specific public goods. To make a decision on whether to become a member, individuals have to compare marginal utilities with marginal costs, including the direct financial costs of contribution and costs of participating in collective decision-making regarding the organisation of production and supply of the goods in question. The second category of costs essentially represents the costs of designing and setting up the facilities needed to implement the production and supply; the size of these costs is determined, among other things, by the homogeneity of membership interests as well as the number of members. To an important extent, these are "one-time", and sunk, costs. They are necessary to initialise a mutual benefit nonprofit, but are essentially no longer relevant for the task of maintaining the established operation. Therefore, it becomes possible that some individuals do not face the initial relatively high costs of initialising a nonprofit and instead join once it has been created. Therefore, there are two possible categories of members: those which agree to incur the costs of setting up a nonprofit, in addition to the costs of maintaining it, and those which prefer only to bear the maintenance costs.<sup>25</sup> Interestingly, although these costs can be substantially different, free-riding behaviour does not represent a problem here, because members will be self-selected in each category by comparing their individual expected marginal utilities and marginal costs.

The possibility of facing different membership costs evidently encourages the membership of individuals with relatively low marginal utilities from the public goods thereby produced. Although such individuals will choose not to incur the costs of setting up a nonprofit, they will choose to join once it is there, because it provides sufficient information on the opportunities of becoming a member, and particularly, on the involved costs and benefits. The transaction cost-economising effect lies in the fact that these costs and benefits do not have to be calculated and/or negotiated by prospective members themselves; rather, this information is provided for free. Here, similarly to the case of public benefit nonprofits, mutual benefit nonprofits allow some individuals to avoid some transaction costs and thus increase the total amount of nonprofit activities. In this case, the reduction of transaction costs leads to the fuller satisfaction of members' needs in specific public goods.

This conceptualisation of the transaction cost-economising effect of mutual benefit nonprofits can also be applied to co-operative organisations and thereby serve to extend its understanding from the viewpoint of transaction cost theory. Indeed, it has been long recognised that the existence of cooperatives allows their members to keep the cost of spe-

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<sup>25</sup> In the terminology of Dülfer (1995), p. 42, these two categories of members can be designated as those who desire higher and lower intensities of co-operation, respectively.

cific transactions at a low level.<sup>26</sup> However, this transaction cost-economising effect also implies that transaction costs associated with expanding the co-operative's activities must also decline, thereby leading, to a certain point, to an expansion of these activities. In this sense, the process of economising on transaction costs exhibits, to some extent, a self-reinforcing nature. One mechanism of this self-reinforcement, suggested by the above analysis of mutual benefit nonprofits, consists of membership policies that enable a clearer differentiation between members who desire higher and lower degrees of co-operation.<sup>27</sup>

By way of summary, the contents of opportunism-induced and bounded rationality-induced transaction costs as they are economised by public benefit and mutual benefit nonprofits is presented in Table 1.

		<i>Type of nonprofit organisation</i>	
		<i>Mutual benefit</i>	<i>Public benefit</i>
<i>Type of transaction costs</i>	<i>Opportunism-induced</i>	Costs of free-riding (avoiding paying for public goods)	Costs of monitoring the use of contributed resources
	<i>Bounded rationality-induced</i>	Costs of decision-making regarding the organisation of production and supply of goods and services to members	Costs of decision-making regarding configuration of donating and costs of devising contracts for charitable activities

*Tab. 1: Transaction costs economised by nonprofits*

*Source: own presentation*

### 3. Integrating bounded rationality-induced and opportunism-induced transaction costs

Whereas the proposed extension of the transaction cost understanding of nonprofit organisation focuses on bounded rationality-induced transaction costs and the standard approaches – respectively on opportunism-induced costs, this should not hide the fact that nonprofits economise on both types of these costs simultaneously. This subsection will seek to integrate both types of these costs in a single conceptual framework represented by the model of decision-making of an individual regarding the determination of the amount of resources to be contributed to public benefit and mutual benefit nonprofits. The model assumes that an individual determines this amount by equating the marginal utility of contributing with its marginal costs, which consist of marginal direct costs (i.e.,

<sup>26</sup> See Bonus (1986); Röpke (1992).

<sup>27</sup> See Dülfer (1995), p. 42.

marginal monetary value of the contributed resources)<sup>28</sup> and both opportunism-induced and bounded rationality-induced marginal transaction costs.

The effects of transaction costs on the realisation of nonprofit activities are schematically represented in Figure 1. As shown in the figure and emphasised in the previous discussion, these effects are essentially similar for both types of transaction costs and lie in reducing the amount of resources that can be voluntarily contributed both for charitable purposes (in the case of public benefit nonprofits) and for serving the members (in the case of mutual benefit nonprofits). By reducing transaction costs, nonprofits facilitate more contributions.

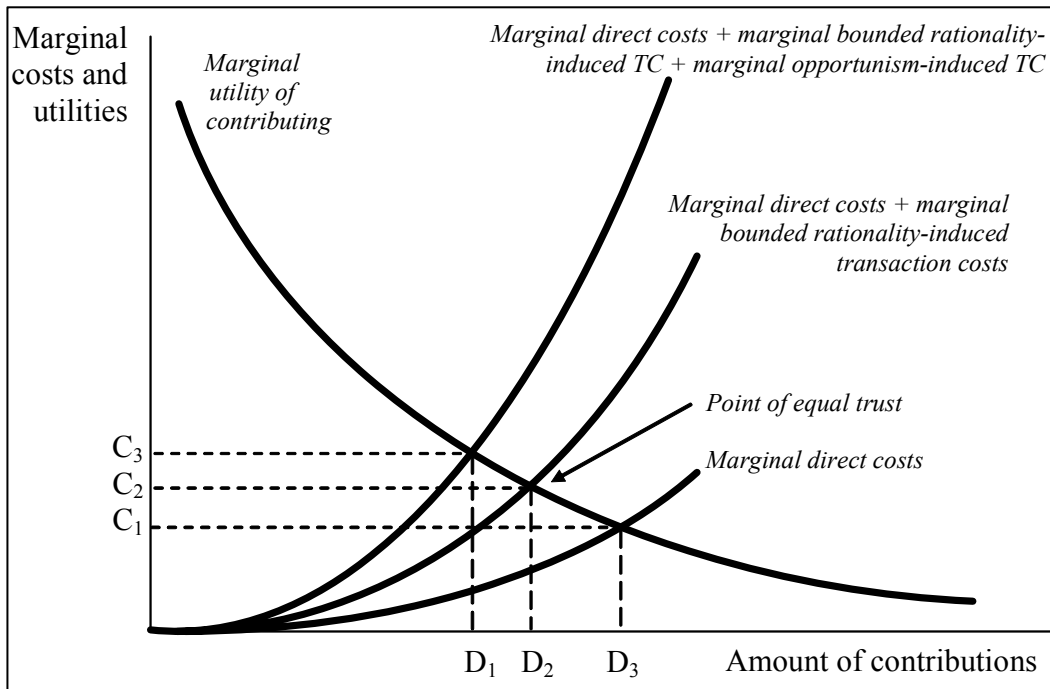


Fig. 1: *Determination of the amount to be contributed to a nonprofit by an individual*

Source: own presentation.

The above figure hypothetically shows that in the absence of nonprofits, the amount of contributions would be equal to  $D_1$  (possibly represented by charitable donations directly to third-party beneficiaries, or by member contributions made in the framework of informal mutual self-help arrangements). The total amount of contributions enabled by nonprofits, according to the figure, is represented by the difference between  $D_3$  and  $D_1$ .

The indicated separation of bounded rationality-induced and opportunism-induced transaction costs in Figure 1 is arbitrary in the sense that they are economised simultaneously;

28 An even more exact representation of the direct costs of contributing could be achieved by using not the sheer monetary value of contribution, but rather the subjectively perceived value of this monetary value. The subjectively perceived values might depend, aside from the monetary values themselves, on the socio-economic status of the contributor (the higher is his income, the lower subjective values would be attached to the same monetary values) or on his subjective evaluation of the importance of specific contributions (i.e., the urgency of needs that the contributions are intended to address). The importance of contributions in this sense can be assumed to be inversely proportional to their subjective value, given the same monetary value. Since the identification of subjective values in the described way occurs at the level of one decision making individual, no interpersonal comparisons are necessary.

one cannot argue that, with reference to the situation where the two types of transaction costs exist, the introduction of a nonprofit organisation helps economise opportunism-induced costs and then bounded rationality-induced costs, as is demonstrated in the figure. Yet, this separation can be justified by illustrating that eliminating opportunism-induced transaction costs by itself still does not maximise the amount of contributions. Rather, one can think of what may be designated as a "point of equal trust" – the point where for-profit and nonprofit firms are assumed as equally trustworthy in the case of public benefit nonprofits or all individuals requiring certain public goods can be assumed not to free-ride in the case of mutual benefit nonprofits<sup>29</sup>. Whereas the transaction cost approaches available in the literature would argue that nonprofits (especially of public benefit type) would become redundant in this situation, the approach presented here suggests that nonprofits would still permit economising on transaction costs, and specifically allow a reduction in their size from  $C_2$  to  $C_1$ , thereby yielding an increase of contributions from  $D_2$  to  $D_3$ .

#### IV. Are the two types of transaction costs equally important?

The proposition of drawing a theoretical distinction between opportunism-induced and bounded rationality-induced transaction costs provokes the question of whether nonprofit organisation reduces them with equal efficiency or whether one type of costs is economised more efficiently than the other. If the latter were found to be the case, arguing that the type of costs more efficiently economised is more significant for explaining the existence of nonprofits than the other would be justified. Identifying direct answers to these questions is of course complicated by the known difficulties and ambiguities involved in measuring and defining transaction costs.<sup>30</sup> Nevertheless, some general observations based on the available literature can be made.

The reduction of opportunism-induced transaction costs presupposes a reduction in the extent of opportunistic behaviour; at the same time it is known that nonprofits are not generally free from opportunism. This is particularly confirmed by the existence of fraud, self-dealing and other forms of abuse in some nonprofits.<sup>31</sup> After reviewing the relevant empirical literature, *Ortmann* and *Schlesinger*<sup>32</sup> established that there is no evidence conclusively suggesting that, in comparison to for-profits, opportunism in nonprofits is higher or lower<sup>33</sup>.

29 It has to be pointed out that according to the logic of the Figure, at the "point of equal trust" which assumes no danger of opportunism, the amount of contributions will be larger than in the situation where opportunism is possible regardless of whether nonprofit organisation exists or not. This point can therefore be interpreted in two ways: 1) as the reduction of opportunism-induced transaction costs achieved through the operation of nonprofits; 2) as a hypothetical situation where opportunism does not exist and but nonprofits are still necessary.

30 See e.g. Furubotn/Richter (1998).

31 See e.g. Gibelman/Gelman (2001); Gibelman/Gelman (2004); Glaser (1994); Lewis (2000).

32 See Ortmann/Schlesinger (1997).

33 See also James (1983); James (1986).

Whereas explicit frauds constitute rather extreme cases of opportunism, its more subtle and indirect form is represented in the phenomenon of goal displacement in the governance of nonprofits.<sup>34</sup> Managers of nonprofits can direct the use of scarce resources to promote their own interests rather than the officially-stated missions of their organisations, particularly in the form of higher remuneration and more intensive on-the-job consumption. *Rose-Ackerman*<sup>35</sup> argues that managerial shirking in nonprofits is promoted by the absence of residual claimants and of markets in ownership shares, which exercise a disciplining influence on for-profit firms. Shirking naturally results in lower efficiency and higher operational costs. Considering the significant heterogeneity of the nonprofit sector it is hardly possible to make any sweeping empirical generalisations on this issue. Yet, it can be established at least at a theoretical level that the costs of monitoring managerial behaviour are likely to be, on average, higher in nonprofits than in for-profit firms due to the lack of otherwise available disciplining mechanisms.

This suggests that at least in some cases, the efficiency of economising on opportunism-induced transaction costs by nonprofit organisation is unlikely to be high; rather, nonprofits seem to substitute one kind of opportunism (which would occur if they did not exist) with another kind (occurring within them). This fact may represent another criticism of those transaction cost theories of nonprofit organisation that focus exclusively on its assumed ability to economise on opportunism-induced transaction costs, unless it can be shown that the extent of opportunism prevented by the creation of a particular nonprofit exceeds that which resulted from its creation. Nonetheless, in view of the actual existence of opportunism in at least some nonprofits, economising on opportunism-induced transaction costs can hardly represent a sufficient transaction cost explanation of nonprofit organisation.

At the same time, it appears that nonprofits economise on bounded rationality-induced transaction costs much more efficiently since their public relations strategies and fundraising campaigns deliver a wealth of information to potential contributors regarding the purposes of the desired contributions and the way in which the contributions will be used. Here, transaction cost-economising effects can be considered self-evident. Consequently, at least in some cases, economising on bounded rationality-induced transaction costs represents a more significant explanation for the existence of nonprofit organisation than does economising on opportunism-induced costs. If we assume that a particular nonprofit does not reduce the total amount of opportunism, but efficiently reduces the uncertainty of potential contributors regarding the best use of their contributions, then the creation of this nonprofit would still be expedient, and moreover, consistent with the transaction cost economising logic.

*Finally, it should be pointed out that it is hardly possible to argue that one type of transaction costs is generally more important for nonprofit organisation than the other. Rather, this is likely to differ for nonprofits operating in various institutional environments, and the identification of the types of transaction costs on which specific types of nonpro-*

34 See Ben-Ner/Hoomissen (1993).

35 See Rose-Ackerman (1996).

*fits economise most efficiently appears to be a promising direction for further empirical research.*

## V. Conclusions

The argumentation offered in this paper has sought to demonstrate that transaction cost-economising logic can not only be reconciled with the major theories of nonprofit organisation (such as contract failure and public goods theories) but also used to generate new hypotheses supplementing the existing theoretical contributions. Specifically, it has been proposed to differentiate between two types of transaction costs reduced by nonprofits: opportunism-induced, which have been emphasised by the existing transaction cost approaches, and bounded rationality-induced, which are conditioned by shortages of information and the limited information processing abilities of individuals who can contribute resources to nonprofits. Economising on bounded rationality-induced transaction costs is particularly relevant for public benefit and mutual benefit nonprofits.

For the former, these costs are represented by decision-making costs regarding the configuration of donating and costs of devising contracts for charitable activities; for the latter, by costs of collective decision-making regarding the organisation of production and supply of goods and services to members. By reducing these costs, public benefit nonprofits permit an increase in the total amount of charitable contributions, and mutual benefit nonprofits enable better service to individuals with lower intensities of need in specific public or collective goods. These effects suggest that in specific areas, people prefer to deal with nonprofits not because they are more trustworthy (or better able to reduce free-riding) but rather because they save these people significant information and negotiation costs.

This conclusion is further confirmed by the fact that existing nonprofits are generally not free from opportunism, and it is therefore not clear if they effect a significant reduction in opportunism-induced transaction costs; economising on bounded rationality-induced transaction costs, however, is much more evident, which may in some cases represent a major factor in explaining the existence of nonprofit organisation.

Transaction costs that have been discussed in this paper occur in the process of coordination among individual stakeholders of nonprofit firms such as donors, volunteers, directors, and employed staff. Yet another types of coordination affecting the operation of many nonprofit firms include their coordination between each other (which is particularly important e.g. in the health care sector, where this coordination may take the form of negotiation and arbitration) as well as coordination with for-profit firms. Inter-firm coordination, both within and outside the nonprofit sector, also generates transaction costs, which if economised on must have implications for the organisational structures and governance processes used in nonprofit firms. Exploring these implications presents a promising direction for further development of the transaction cost theory of nonprofit organisation.

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