

Valentinov, Vladislav

Article — Published Version

The transaction cost theory of the nonprofit firm: Beyond opportunism

Nonprofit and Voluntary Sector Quarterly

Provided in Cooperation with:

Leibniz Institute of Agricultural Development in Transition Economies (IAMO), Halle (Saale)

Suggested Citation: Valentinov, Vladislav (2008) : The transaction cost theory of the nonprofit firm: Beyond opportunism, Nonprofit and Voluntary Sector Quarterly, ISSN 1552-7395, Sage Publ., London [u.a.], Vol. 37, Iss. 1, pp. 5-18, <https://doi.org/10.1177/0899764007300408>

This Version is available at:

<http://hdl.handle.net/10419/195126>

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.

The Transaction Cost Theory of the Nonprofit Firm: Beyond Opportunism

Vladislav Valentinov

*Leibniz Institute of Agricultural Development
in Central and Eastern Europe*

Building on the transaction cost theory of the for-profit firm, the article argues that the transaction cost-economizing role of the nonprofit firm has two distinct dimensions. One of them consists of reducing the cost of searching for, processing, and communicating information and the other minimizes opportunistic behavior by means of aligning incentives of concerned stakeholders. So far, the transaction cost theory of the nonprofit firm has been emphasizing the second dimension while largely ignoring the first one. The article fills this gap by demonstrating that nonprofit firms are able to economize on transaction cost not only by minimizing opportunism but also by facilitating cooperation among those stakeholders who derive utility from contributing to the realization of their nonprofit firm's missions and hence would not be interested in opportunistic behavior. The article concludes by emphasizing the complementarity of the two dimensions of the nonprofit firm's transaction cost-economizing role.

Keywords: *nonprofit firm; transaction cost; information cost; opportunism*

The concept of transaction cost has figured prominently in a number of important theoretical explanations of the existence of the nonprofit firm in a market economy. The economic role of the nonprofit firm has been shown to consist of ensuring a more efficient economizing on transaction cost than could be achieved by alternative institutional arrangements for certain types of transactions characterized by information asymmetry (Krashinsky, 1986). The classic examples of these transactions include donative financing (Fama & Jensen, 1983; Hansmann, 1980) and procurement of products and services

Note: This research has been supported by the Marie Curie Incoming International Fellowship of the Sixth Framework Program of the European Community (Contract No. MIF1-CT-2005-514036). The author is grateful to the anonymous reviewers for valuable comments. The views expressed in the article are those of the author only. The European Commission is not liable for any use that may be made of the information contained in this publication.

Nonprofit and Voluntary Sector Quarterly, vol. 37, no. 1, March 2008 5-18

DOI: 10.1177/0899764007300408

© 2008 Association for Research on Nonprofit Organizations and Voluntary Action

whose quality cannot be properly evaluated by consumers (Ben-Ner, 1986; Easley & O'Hara, 1986; Hansmann, 1980). Because the nondistribution constraint assures donors and consumers that the firm owners have no incentives to opportunistically exploit the respective information asymmetry, donors and consumers will regard these firms as more trustworthy and hence will be more willing to realize the transaction in question.

In an important sense, these rationalizations of the nonprofit firm follow the methodological pattern of some of the transaction cost theories of the for-profit firm. Specifically, they visualize the nonprofit firm as an institution achieving the minimization of opportunistic behavior through the appropriate alignment of incentives of concerned stakeholders. Indeed, the for-profit firm also has been explained as a contractual arrangement aimed at minimizing opportunistic behavior that may occur in the framework of team production (Alchian & Demsetz, 1972) or interfirm cooperation (Klein, Crawford, & Alchian, 1978; Williamson, 1985). High transaction cost, information asymmetries, and the structure of incentives naturally play a key role in these explanations as well.

Yet, the transaction cost theory of the for-profit firm consists of two conceptually distinct strands of literature, only one of which has been adequately paralleled by the evolution of theoretical understanding of nonprofit organization. These two strands can be designated as the incentive alignment approach and the Coasean approach. The former approach places the economic role of the for-profit firm in the structuring of the economic agents' incentives in such a way that opportunistic behavior is minimized, in spite of the existing information asymmetries. By contrast, the latter approach is more general in its assumptions. It does not assume information to be distributed in a specifically asymmetric fashion; rather, it assumes economic agents to be equally limited in their capacity to search for, process, and communicate information. Accordingly, the latter approach locates the economic role of the for-profit firm not in minimizing opportunism but in minimizing the cost of handling information (i.e., transaction cost in the Coasean understanding¹), without any recourse to the problem of opportunism and the associated need to align incentives. The latter approach has been initiated by Coase (1937) and continued in other writings emphasizing the role of the for-profit firm in reducing the cost of searching for, processing, and communicating information (e.g., Malmgren, 1961; Radner, 1992).

Clearly, the development of the transaction cost theory of the nonprofit firm has proceeded so far basically in the tradition of the incentive alignment approach. Indeed, the incentive alignment-related concepts of opportunism, information asymmetries, output observability, monitoring cost, and trustworthiness have been center stage in the available transaction cost analyses of nonprofit organization. Yet, the emphasis on incentive alignment, however relevant and useful in itself, does not sufficiently bring to light the role of nonprofit firms

in reducing the cost of searching for, processing, and communicating information, regardless of the problem of opportunism. This article will seek to make a first step in filling this gap; it will demonstrate that nonprofit firms are able to economize on transaction cost not only in the form of aligning incentives to minimize opportunistic behavior. In a sense, this article will seek to draw the implications of Coase's (1937) article for the context of nonprofit organization.

The distinction between the two above-mentioned approaches to the theory of the for-profit firm has been proposed by Demsetz (1988). His aim, though, of introducing it has been to some extent contrary to the aim of reinforcing it in the present article. Indeed, Demsetz sought to demonstrate that the incentive alignment theories of the for-profit firm, while necessarily building on the Coasean insights, significantly expand their explanatory power. In his own words, "moral hazard analysis, shirking, and opportunism—the problems of incentive compatibility—yield explanations of the internal organization of the firm that are difficult to derive from transaction cost considerations alone" (Demsetz, 1988, p. 153). His argument reflected the dynamics of the evolution of the transaction cost theory of the for-profit firm—from the general recognition that "there is a cost of using the price mechanism" (Coase, 1937, p. 390) to its implication that incentive configuration must matter. By contrast, the transaction cost theory of the nonprofit firm has started by envisaging it as a solution to the incentive alignment problem while skipping, as it were, the more basic issues of cost of processing and communicating information as emphasized in Coase's (1937) article and related works.

To reduce the risk of misinterpretation, let it be stated that both of the above-mentioned strands in the transaction cost theory of the for-profit firm—designated here as the incentive alignment approach and the Coasean approach—must have been equally important for the development of that theory, and there are no grounds for a different opinion on this point for the case of the transaction cost theory of the nonprofit firm as well. Although this article will discuss transaction cost-economizing in nonprofit firms without recourse to any incentive alignment issues, such as trustworthiness or output observability, it should not be taken to mean that these issues are treated as unimportant or unrelated to the cost of transacting. Evidently, understanding economic organization of both for-profit and nonprofit firms requires paying attention to both of these approaches at the same time. The exposition of the transaction cost-economizing role of the nonprofit firm in this article will be one-sided in the sense of emphasizing only the Coasean approach and will be intended to supplement the well-known theories belonging to the incentive alignment approach.

The development of the transaction cost theory of the for-profit firm has basically involved two steps: relaxing the zero-transaction cost assumption of the neoclassical price theory and identifying the ways in which for-profit

firms economize on positive transaction cost. This methodological pattern will provide guidance for the construction of the argument in the present article as well. The next section explores how the activities that are undertaken by nonprofit firms in the real world would be organized in the zero-transaction cost world assumed by the neoclassical economics. Subsequent sections analyze how the organization of these activities would be affected by relaxing the zero-transaction cost assumption and how real-world nonprofit firms arise to economize on transaction cost, beyond considerations of minimizing opportunistic behavior by means of aligning incentives. Finally, I will examine how the occurrence of opportunistic behavior in the real world affects the realization of this opportunism-independent transaction cost–economizing function by nonprofit firms.

DEFINING THE NEOCLASSICAL NONPROFIT FIRM

In the neoclassical price theory, for-profit firms are defined as the units of production, just as households are defined as the units of consumption (Putterman & Kroszner, 1996, p. 8). A crucial distinction between production and consumption can be drawn with respect to their motivating mechanisms. Demsetz (1988) formulates it as follows:

Consumption, by definition, creates utility, so the household's decisions in theory are utility-maximizing decisions. Production is devoid of direct utility-creating activities (which are defined as consumption), so the firm's decisions are guided only by profit considerations. However, the maximization of the firm's profit delivers to its owners a maximum capability for (indirect) utility-creating consumption in their households. The entire process really is concerned with utility maximization, but some activities, identified as production (for use by others), deliver utility indirectly to factor owners through the easing of their household budget constraints. (p. 189)

The distinction between utility and profit maximization provides a simple (and somewhat paradoxical) definition of the neoclassical nonprofit firm: This is a firm that maximizes not profit but utility. Put differently, similar to the for-profit firm is the unit of profit-driven production; the nonprofit firm is the unit of what may be termed utility-driven production. In itself, this is of course not a new finding: Its early systematic treatment forms the core of James's (1983) model, which has been later extended in numerous ways to take account of various aspects of utility, such as output, quality, technological preference, and ideology (see, e.g., James & Rose-Ackerman, 1986). Given the orientation of nonprofit firms toward utility rather than profit maximization, the production that they engage in represents a peculiar

hybrid between production and consumption, just as these firms themselves can be designated as a hybrid between the profit-maximizing firm and the utility-maximizing household. Specifically, the nonprofit firm is similar to the profit-maximizing firm in that it carries out production; yet, it is dissimilar from the profit-maximizing firm and similar to the household in that it maximizes utility rather than profit.

The fact that a certain production is utility-driven is sufficient, by itself, to explain why this production is undertaken on the nonprofit basis. The explanation is simple: Economic agents will take actions that maximize their utility and, accordingly, will carry out a utility-driven production for exactly this purpose, without regard to whether this production is profitable (but taking account, of course, of the opportunity costs of resources used up in this production). Self-evident as it is, this (neoclassical) explanation of the nonprofit firm stands in an interesting contrast to some of the existing neoclassical models of the nonprofit firm, which assume that nonprofit managers maximize utility because they cannot maximize profit due to the nondistribution constraint (see James & Rose-Ackerman, 1986). The concept of utility-driven production presupposes a reverse causation: Nonprofit firms' managers do not care about profit precisely because they seek to maximize their utility in the form of carrying out a certain production.

To be sure, the neoclassical definition of the nonprofit firm—as the unit of utility-driven production—is no more helpful for understanding the operation of the real-world nonprofit firms than the neoclassical definition of the for-profit firm is helpful for understanding the operation of the real-world for-profits. Indeed, in the neoclassical zero-transaction cost world, profit-driven production could be organized by what Putterman and Kroszner (1996) call “momentary assemblages of cooperating factor suppliers,” implying that these suppliers “agree today to contribute their inputs at the going rate so as to produce something for which an unmet demand is perceived, divide any surplus earnings, and go their separate ways tomorrow according to newly observed opportunities” (p. 8). Clearly, in the zero-transaction cost world, similar momentary assemblages based on voluntary cooperative agreements could govern utility-driven production as well.

Needless to say, economic organization in the form of momentary assemblages is hard to reconcile with the way both for-profit and nonprofit firms are organized in the real world. Specifically, the neoclassical price theory cannot explain why the real-world firms, both for-profit and nonprofit, (a) involve the reliance on long-term contracts between input providers and (b) exhibit an assignment of control rights in which some agents hire others and direct them in the activities of production (Putterman & Kroszner, 1996). If the concept of the firm is defined by these two characteristics rather than by its function of carrying out production, then firms have really no role to play in a hypothetical economy based on the costless operation of the price mechanism. As Coase insightfully observed in his 1937 article, the reliance

on long-term contracts between input providers and the employment relationship become explicable only when the zero-transaction cost assumption is dropped. The next section will analyze some implications of dropping this assumption for explaining the real-world nonprofit organization.

INTRODUCING POSITIVE TRANSACTION COST

The transaction cost theory of the for-profit firm (more specifically, the part of this theory that has been labeled above as the Coasean approach) rationalizes this firm as a means of economizing on the cost of searching for, processing, and communicating information that must be incurred by the owners of production factors in the process of cooperating with each other. In the positive transaction cost world, "momentary assemblages of cooperating factor suppliers" would be too costly to maintain because their continuous renegotiation would require extensive search for and exchange of information, quite independently from the problem of opportunism. By replacing these momentary assemblages with long-term contracts and authority-based, rather than price-based, resource allocation, the for-profit firm achieves a reduction in the cost of handling information to the level that is bearable to the cooperating factor suppliers.

Essentially the same story can be told about nonprofit firms. Realization of utility-driven production requires cooperation of factor suppliers. In the positive transaction cost world, organization of this cooperation in the form of momentary assemblages would be too costly. Thus, the real-world nonprofit firm emerges as a means of organizing utility-driven production economically. The only distinction of cooperation of factor suppliers in utility-driven production from their cooperation in profit-driven production resides in the fact that in the former type of production, at least some of the factor suppliers must enhance their utility by engaging in this production, whereas profit-driven production is not required to directly affect anyone's utility. It is, however, noteworthy that utility-driven production does not require all of the cooperating factor suppliers to derive positive utility from it; those who do not derive such utility may participate in this production in return for monetary compensation. Participation of such disinterested factor suppliers is expedient if it allows realization of economies of scale (i.e., reduction in average production costs) that are capitalized by those factor suppliers whose utility is directly affected by this production.

By analogy with the transaction cost theory of the for-profit firm, the existence of positive transaction cost must exert a twofold effect on the organization of utility-driven production. Namely, it must affect the total amount of this production, which is actually undertaken in an economy, as well as the delineation of organizational boundaries of individual nonprofit firms. In the rest of this section, these relationships will be considered in more detail.

The first of these relationships—the one between the total amount of utility-driven production that is actually undertaken and the size of transaction cost—can be inferred from Demsetz's (1997) critique of the Coasean theory of the for-profit firm. Demsetz (1997) argued that the size of transaction cost in an economy determines the boundary between the reliance on specialization and exchange, on one hand, and self-sufficiency, on the other. Specifically, an increase in transaction cost reduces the range of specialization and exchange and thereby curtails the total extent of production activities undertaken by for-profit firms. In the same vein, transaction cost stands in the way of cooperation of factor suppliers in utility-driven production. Organization of this production in the form of nonprofit firms, rather than momentary assemblages, clearly reduces transaction cost but cannot eliminate it completely. Hence, there will always remain in a real-world economy some positive, residual transaction cost that cannot be reduced further and therefore must be unavoidably incurred by economic agents. The size of this residual transaction cost will determine the extent by which the overall volume of utility-driven production in the real world will fall short of this volume in the hypothetical world of zero-transaction cost. This conclusion, though, does not allow any inferences regarding the size or organizational boundaries of individual nonprofit firms, which is the object of the second above-mentioned relationship.

The second relationship—the one between the size of transaction cost and the size of individual nonprofit firms—is more complex for nonprofit firms than it is for for-profit ones. In the for-profit context, this relationship has been formulated by Coase (1937) as follows: "A firm will tend to expand until the costs of organizing an extra transaction within the firm become equal to the costs of carrying out the same transaction by means of an exchange on the open market" (p. 395). Evidently, in the determination of the size of nonprofit firms, the comparison between intrafirm and extrafirm transaction costs must be supplemented with the account of utility derivable from production activities that can be placed either within or outside these firms' organizational boundaries. Specifically, decisions on vertical integration or disintegration (outsourcing) will be informed by the extent to which particular production activities are utility-enhancing rather than be made on the basis of transaction cost considerations alone. In contrast to the situation in for-profit firms, nonprofit managers can decide to vertically integrate into some activities because they consider these activities to be utility-enhancing or they can decide to abstain from outsourcing some utility-enhancing activities even if this outsourcing is indicated by transaction cost-economizing reasons. In a general case, there exists a trade-off between efficiency-related and utility-related reasons for defining nonprofit firms' organizational boundaries.² Because the rationale behind the existence of nonprofit firms consists of the enhancement of utility of at least some stakeholders, this

trade-off will be principally resolved by sacrificing efficiency to obtain utility. To be sure, this trade-off does not exist for those activities that are undertaken by nonprofit firms for purely commercial reasons; the decisions on vertically integrating into or outsourcing these activities will be taken in a manner similar to that of for-profit firms.

HOW DO NONPROFIT FIRMS ECONOMIZE ON TRANSACTION COST?

The objective of this section is to bring to light some of the ways in which the real-world nonprofit firms economize on the cost of searching for, processing, and communicating information, quite apart from their role in minimizing opportunistic behavior. These ways will be classified here into two types, one of which can be designated as general, in the sense that they equally apply for both for-profit and nonprofit firms, and the other as specific to nonprofit organization. The general ways in which nonprofit firms economize on transaction cost can be directly inferred from Coase's (1937) article, which identifies two basic aspects of the transaction cost-economizing role of for-profit firms.

First, according to Coase (1937),

Contracts are not eliminated when there is a firm but they are greatly reduced. A factor of production . . . does not have to make a series of contracts with the factors with whom he is cooperating within the firm, as would be necessary, of course, if this cooperation were as a direct result of the working of the price mechanism. (p. 391)

Clearly, the same reasoning applies to nonprofit firms as well. The existence of nonprofit firms significantly reduces the number of contracts that would have otherwise been concluded among all factor suppliers cooperating in a given utility-driven production. Indeed, to participate in this production as it occurs in the real world, each factor supplier needs to conclude a single contract with the firm rather than multiple contracts with all other factor suppliers concerned. The existence of nonprofit firms avoids the costs of writing these multiple contracts.

Second, writes Coase (1937),

It may be desired to make a long-term contract for the supply of some article or service. This may be due to the fact that if one contract is made for a longer period, instead of several shorter ones, then certain costs of making each contract will be avoided. (p. 391)

This aspect of economizing on transaction cost is closely related to the first one, yet it has a different focus: It accentuates that each individual action

undertaken by nonprofit firms does not require the concluding of new contracts between the nonprofit firm and individual factor suppliers, let alone multiple contracts between all cooperating factor suppliers. Rather, such actions are undertaken in the framework of long-term contracts that are based on relatively loose specification of the types of actions that might be undertaken. Coase extends this reasoning to rationalize the employment relationship in a for-profit firm. This reasoning basically holds for nonprofit organization as well, with the understanding that the employment relationship does not need to imply hierarchical subordination in every case. What it implies is the agreement to perform activities within a prespecified range during a certain period, and this is exactly what cooperation between individual factor suppliers envisages.

The general ways in which nonprofit firms economize on transaction cost—reduction in the number of contracts and the substitution of long-term contracts for short-term contracts—are based on the assumption that cooperating factor suppliers are aware of each other's existence. This awareness, however, cannot be taken for granted; rather, it is created and maintained by the continuous process of search undertaken by each individual factor supplier. Needless to say, the search process involves a transaction cost of its own. The special role of nonprofit firms in economizing on this element of transaction cost follows from an important difference in the nature of the search process required to enable cooperation in utility-driven production, on one hand, and profit-driven production, on the other.

Specifically, the search process required for cooperation in profit-driven production does not need to focus on identifying factor suppliers who are motivated by the prospect of monetary gain because this motivation is assumed as universally relevant (and directly following from the utility maximization postulate). By contrast, utility-driven production is undertaken by factor suppliers, at least some of which must be able to derive direct satisfaction from this production, that is, have at least some arguments in their utility functions in common. Clearly, this is a much more restrictive motivational prerequisite than is presupposed by the prospect of monetary gain. Hence, factor suppliers having a specific utility function will incur greater cost of searching for other factor suppliers who have a similar utility function than factor suppliers motivated by monetary gain will respectively incur in locating other factor suppliers who also are motivated by monetary gain. The greater search cost necessary for undertaking utility-driven production can be reduced by nonprofit firms if they actively inform the general public about their missions, activities, and resource requirements (particularly in the form of fundraising campaigns). The information provided to the general public reaches factor suppliers having utility functions of the required kind. These factor suppliers (such as donors, volunteers, and individuals willing to accept relatively low wages) become thereby aware of the existence of other similarly motivated factor suppliers without incurring the

cost of individual search. As a result, they acquire a chance to join certain established kinds of utility-driven production in nonprofit firms and thus contribute to expanding the overall volume of utility-driven production in an economy.³

The ability of nonprofit firms to reduce search costs of individual factor suppliers is particularly important in two cases: (a) when these factor suppliers desire their own number to be large and (b) when they have only low intensities of preference for specific kinds of utility-driven production. In the former case, this desire may stem from the sheer fact that mutual communication of these factor suppliers directly enhances their utility, or it may be explained by the reduction in average cost of utility-driven production if its output expands (i.e., by the presence of economies of scale). Clearly, the more factor suppliers must be involved, the higher must be the associated search cost, and hence, the more important must be the transaction cost-economizing role of nonprofit firms.

In the second case, those factor suppliers whose respective preference intensity is low are unlikely to participate in utility-driven production if they have to incur a substantial search cost. Indeed, their participation becomes realistic only when they can avoid the search cost by benefiting from the information freely provided by the existing nonprofit firms. To give a hypothetical example, in a society there might exist individuals with a low intensity of preference for supporting people in the Third World. Accordingly, these individuals would be ready to contribute certain resources for achieving this purpose, yet because their preference intensity is low, the size of each individual contribution would be insignificant. If in this society there are nonprofit firms whose mission is to support people in the Third World, these firms can create the opportunity for making small donations while providing the necessary information about the ways that these donations will be utilized to achieve the above-mentioned purpose. Evidently, if the opportunities of making these small but well-informed donations were not available, many donations would not be made because the cost of searching for an opportunity to support people in the Third World, given the low intensity for this preference, might well exceed the utility derived from realizing this opportunity.

THE EFFECT OF OPPORTUNISM

The preceding discussion has demonstrated that in itself, the nonprofit firms' ability to reduce the cost of searching for, processing, and communicating information does not depend on the existence of opportunistic behavior of nonprofit firms' stakeholders. Yet, such behavior is known to exist and has even been found to be no less characteristic of nonprofit than of for-profit firms (e.g., Ortmann & Schlesinger, 1997). Hence, it is legitimate to ask

how the empirical existence of opportunistic behavior affects the way nonprofit firms exercise their opportunism-independent transaction cost-economizing function, even if their principal ability to do so is conceptually unrelated to the occurrence of such behavior.⁴

Evidently, the answer to this question lies in recognizing that greater expectations of being confronted with opportunism will generally reduce the willingness of individuals to cooperate in utility-driven production, even if these individuals incur only a low cost of searching for, processing, and communicating information about opportunities of involvement in specific nonprofit firms. Nonprofit firms can indeed lower the cost for individuals of learning about these opportunities, yet the extent to which the concerned individuals will respond to this cost reduction by expanding their demand for such opportunities will depend on their trust that their involvement will not be opportunistically exploited. The level of this trust, therefore, will determine the extent to which the concerned individuals will make use of the opportunism-independent transaction cost-economizing function of nonprofit firms.

This trust can be promoted by a number of institutional devices, the most important of which include the nondistribution constraint and the enhanced consumer control, as follows from the trustworthiness and consumer control theories of nonprofit organization (Ben-Ner, 1986; Hansmann, 1980), respectively. By constraining the potential for opportunistic behavior, both the nondistribution constraint and the enhanced consumer control increase the value that individuals place on the nonprofit firms' ability to reduce the cost of searching for, processing, and communicating information. Given that the quality of enforcing these institutional devices may vary, better enforcement will be associated with the greater use that will be made of this ability.

Furthermore, the likelihood of opportunistic behavior of nonprofit firms' stakeholders can be reduced through signaling and screening mechanisms. Signaling may involve, for example, acceptance by employees of lower wages than they could earn elsewhere. The acceptance of lower wages is only possible when the concerned employees obtain nonmonetary utility that compensates them for the lack of the monetary remuneration. Clearly, individuals who do not derive such utility and therefore would be particularly prone to opportunism will perceive these wages as falling short of the opportunity cost of their labor and will abstain from entering these firms.⁵ The screening role of the nonprofit organizational form is based on its tendency to attract only those managers who can restrain their desire for earning profit (Young, 1983). Admittedly, those managers who can do so will be less likely to engage in opportunistic behavior than those who cannot.

Thus, the account of opportunistic behavior reveals a peculiar complementarity between the Coasean and the incentive alignment approaches to understanding the transaction cost-economizing function of nonprofit firms. Although the Coasean approach, which is advocated here, rationalizes this function without recourse to the task of minimizing opportunism, its empirical

relevance is circumscribed by the operation of institutional devices ensuring that opportunistic behavior is kept within bounds. The importance of these devices is emphasized by those theories that locate the nonprofit firms' role in aligning their stakeholders' incentives. To be sure, this complementarity can be conceptualized from the obverse side as well: The empirical importance of the nonprofit firms' role in aligning incentives is enhanced when nonprofit firms can effectively lower the cost of searching for, processing, and communicating information. Because lowering this cost makes engaging in utility-driven production more attractive, the issues of ensuring incentive compatibility will thereby become increasingly relevant.

CONCLUDING REMARKS

This article can be summarized by considering a hypothetical question: Would nonprofit firms have a role to play in an economy where information is scarce but people are not prone to opportunism? Evidently, theories rationalizing the nonprofit firm as a means of minimizing opportunistic behavior, such as the trustworthiness theory (Hansmann, 1980) and the consumer control theory (Ben-Ner, 1986), must answer this question negatively. By contrast, this article suggested that even if people are not opportunistic, their cooperation in the realization of utility-driven production involves a transaction cost associated with the processes of searching for, processing, and communicating information, which are unrelated to the problem of preventing opportunism. Nonprofit firms arise to economize on this transaction cost by reducing the number of contracts that needs to be made among the participants of utility-driven production, by replacing short-term contracts with long-term ones, and by reducing the cost to the participants of searching for opportunities of involvement in this production.

The validity of this argument, of course, does not depend on the assumption that people are not prone to opportunism. Indeed, they are, as has been forcefully postulated by Williamson's (1985) version of transaction cost economics. The proclivity to opportunism suggests that the economic role of nonprofit firms in the real world is twofold. On one hand, nonprofit firms do reduce opportunism by means of aligning incentives among concerned stakeholders, as argued by Hansmann (1980), Ben-Ner (1986), Easley and O'Hara (1986), Krashinsky (1986), and others. On the other, they also economize on the cost of searching for, processing, and communicating information. These are two complementary aspects of the general transaction cost-economizing role of nonprofit firms. Moreover, these aspects are mutually reinforcing in the sense that the range of empirical relevance of each of them is circumscribed by the extent to which the other aspect is effectively realized.

Although these two aspects must be equally important in principle, it might be conjectured that their actual relative importance can vary across

different (classes of) nonprofit firms. Indeed, the cases of fraud and self-dealing occasionally observed in some nonprofit firms (e.g., Gibelman & Gelman, 2001, 2004) suggest that these firms sometimes do not manage to suppress opportunism sufficiently. In these cases, can minimization of opportunism be regarded as the major rationale behind these firms' existence? Or, do these firms exist mainly because they effectively reduce the cost of searching for, processing, and communicating information? Answering these questions must be left to empirical research.

Notes

1. It is noteworthy that Coase's (1937) seminal article, while laying the foundation for the modern transaction cost theory of the firm, never mentions the issue of incentive alignment aimed at minimizing opportunism. The argument of Coase is wholly in terms of cost of searching for, processing, and communicating information.

2. I am thankful to one of the anonymous reviewers for suggesting this trade-off to me. The discussion of the trade-off follows the implicit Coasean assumption of zero production cost differences between intrafirm and extrafirm organization of production activities. This assumption can be relaxed by permitting these differences to enter into the efficiency-related rationale for specific delineation of organizational boundaries as opposed to utility-related rationale. The nature of the trade-off is clearly not affected by this extension.

3. To be sure, it may happen that no factor suppliers with the required utility function can be identified in a given society; this fact cannot be changed by an active informational policy of nonprofit firms. Or, nonprofits may manage to convince some individuals of the importance of their missions, thus changing these individuals' utility functions, but the activity of convincing falls outside the scope of economizing on transaction cost.

4. I am thankful to one of the anonymous reviewers for suggesting this question to me.

5. This argument is corroborated by the empirical findings that nonprofit firms do tend to pay lower salaries than for-profit ones (Handy & Katz, 1998; Preston, 1989; Steinberg, 1990; Weisbrod, 1983).

References

- Alchian, A., & Demsetz, H. (1972). Production, information costs, and economic organization. *American Economic Review*, 62(5), 772-795.
- Ben-Ner, A. (1986). Nonprofit organizations: Why do they exist in market economies? In S. Rose-Ackerman (Ed.), *The economics of nonprofit institutions: studies in structure and policy* (pp. 94-113). Oxford, UK: Oxford University Press.
- Coase, R. (1937). The nature of the firm. *Economica*, 4, 386-405.
- Demsetz, H. (1988). *Ownership, control, and the firm*. Oxford, UK: Basil Blackwell.
- Demsetz, H. (1997). *The economics of the business firm; seven critical commentaries*. New York: Cambridge University Press.
- Easley, D., & O'Hara, M. (1986). Optimal nonprofit firms. In S. Rose-Ackerman (Ed.), *The economics of nonprofit institutions: Studies in structure and policy* (pp. 85-93). Oxford, UK: Oxford University Press.
- Fama, E., & Jensen, M. C. (1983, June). Separation of ownership and control. *Journal of Law and Economics*, 26, 301-325.

- Gibelman, M., & Gelman, S. (2001). Very public scandals: Nongovernmental organizations in trouble. *Voluntas*, 12(1), 49-66.
- Gibelman, M., & Gelman, S. (2004). A loss of credibility: Patterns of wrongdoing among non-governmental organizations. *Voluntas*, 15(4), 355-381.
- Handy, F., & Katz, E. (1998). The wage differential between nonprofit institutions and corporations: Getting more by paying less? *Journal of Comparative Economics*, 26, 246-261.
- Hansmann, H. (1980). The role of nonprofit enterprise. *Yale Law Journal*, 89(5), 835-901.
- James, E. (1983). How nonprofits grow: A model. *Journal of Policy Analysis and Management*, 2, 350-365.
- James, E., & Rose-Ackerman, S. (1986). *The nonprofit enterprise in market economies*. Chur, Switzerland: Harwood.
- Klein, B., Crawford, R., & Alchian, A. (1978). Vertical integration, appropriable rents and the competitive contracting process. *Journal of Law and Economics*, 21, 297-326.
- Krashinsky, M. (1986). Transaction costs and a theory of the nonprofit organization. In S. Rose-Ackerman (Ed.), *The economics of nonprofit institutions: Studies in structure and policy* (pp. 114-132). Oxford, UK: Oxford University Press.
- Malmgren, H. (1961). Information, expectations, and the theory of the firm. *Quarterly Journal of Economics*, 75, 399-421.
- Ortmann, A., & Schlesinger, M. (1997). Trust, repute, and the role of nonprofit enterprise. *Voluntas*, 8(2), 97-119.
- Preston, A. (1989). The nonprofit worker in a for-profit world. *Journal of Labor Economics*, 7, 38-63.
- Putterman, L., & Kroszner, R. (1996). The economic nature of the firm: A new introduction. In L. Putterman & R. Kroszner (Eds.), *The economic nature of the firm: A reader* (pp. 1-31). Cambridge, UK: Cambridge University Press.
- Radner, R. (1992). Hierarchy: The economics of managing. *Journal of Economic Literature*, 30, 1382-1415.
- Steinberg, R. (1990). Labor economics and the nonprofit sector: A literature review. *Nonprofit and Voluntary Sector Quarterly*, 19(2), 151-170.
- Weisbrod, B. (1983). Wage differentials between the private for-profit and nonprofit sectors: The case of lawyers. *Journal of Labor Economics*, 1, 246-263.
- Williamson, O. (1985). *The economic institutions of capitalism: Firms, markets, relational contracting*. New York: Free Press.
- Young, D. (1983). *If not for profit, for what?* Lexington, MA: Lexington Books.

Vladislav Valentinov is a Marie Curie Fellow based at the Leibniz Institute of Agricultural Development in Central and Eastern Europe in Halle, Germany. His research focuses on the role of the nonprofit sector in rural development.