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Chapter 6

The Role of Trust in Nonprofit Enterprise

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INTRODUCTION

Andreas Ortmann and Mark Schlesinger, in their article "Trust, Repute, and the Role of Nonprofit Enterprise," examine what they term "the trust hypothesis," namely "the claim that asymmetric information in the markets for certain goods and services can explain the existence of nonprofit enterprise in those markets" (this volume). There is much that is sensible in what they say, and they have performed a valuable service in pulling together some of the more recent empirical literature on asymmetric information in markets heavily populated with nonprofit firms. I have some concerns, however, both with respect to the authors' formulation of the trust hypothesis and with their approach to its verification.

HAS THE TRUST HYPOTHESIS BEEN HYPOTHESIZED?

The authors attribute the trust hypothesis principally to me. If "the trust hypothesis" is taken to mean the asymmetric information theory (or, as I originally put it, the "contract failure" theory) offered in my first essay

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(Hansmann, 1980) on the subject, I am happy to be given the credit, though it must be shared with others.[1] But Ortmann and Shlesinger go further, seeming to impute to me what I will term the "strong form" of the trust hypothesis, which we might formulate as follows: The existence and market share of nearly all nonprofit firms that can be found in the United States today can be convincingly explained as an efficient response to problems of asymmetric information.

In support of this attribution, Ortmann and Schlesinger quote me as saying that it is

> ... general scholarly consensus that ... the nonprofit form serves as a crude but effective consumer protection device in severe situations of asymmetric information. More particularly, nonprofit constraints reduce [sic—should be 'nonprofits constrain producer'] opportunism where consumers ... are unable to evaluate accurately the quantity or quality of the service that the firm produces for them. (Ortmann and Schlesinger, 1997, p. 4; elisions by the authors.)

If, however, we restore the material that the authors have elided, the first sentence of my statement actually reads as follows (with the restored material indicated by italics):

> There is general scholarly consensus that *the most convincing efficiency rationale for employing the nonprofit form, as well as the apparent reason why nonprofit firms in fact originally arose in most industries in which they are found, is that* the nonprofit form serves as a crude but effective consumer protection device in severe situations of asymmetric information ... (Hansmann, 1996a.)

Thus, read in full, the quoted statement does not assert anything like the strong form of the trust hypothesis. Rather, it makes two rather different claims—one normative, the other historical—both of which are consistent with the existence of large numbers of nonprofits that today serve no important role as a means of mitigating problems of asymmetric information (i.e., of responding to the "trust" problem).

Indeed, the essay from which the quotation was taken is devoted to an examination of the market share of nonprofit firms—in comparison with that of both for-profit firms and governmental firms—in the same four human service industries that Ortmann and Schlesinger draw on for nearly all their evidence: health care, old age care, day care, and education. Among the principal conclusions I offer in that essay is that the variations we observe in the market share of nonprofit firms—both across industries at any given time, and across time within any given industry—can by no means be explained solely, or even principally, as a response to varying problems of asymmetric information. At the end of their article, Ortmann and Shlesinger quote a recent statement of mine reiterating this view, and suggest that it is a sign that my views have lately been "converging" to theirs. But in fact, for better or worse, my views have always been pretty much the same. From my earliest writings on nonprofits I have expressed serious doubt that problems of asymmetric information in product markets could explain the market share of most commercial nonprofits.[2] I am surprised that my work could be read to say otherwise.

I believe it would also be difficult to find assertions of the strong form of the trust hypothesis from other thoughtful scholars of the nonprofit sector. As a rhetorical matter, the strong form of the trust hypothesis may be a useful way of posing the more serious question at issue, which is the extent to which nonprofit firms are today serving as an effective response to problems of asymmetric information. But as a serious all-encompassing theory of the nonprofit sector, it is a straw man.

Another version of the trust hypothesis that Ortmann and Schlesinger offer, which I will call the "super-strong form," is even more conspicuously a straw man. The authors formulate this version as follows (1997, p. 8):

> [P]roponents of the trust hypothesis implicitly suggest that the opportunities and incentives for various forms of opportunistic behavior on the part of agents (boards as regards donors, managers as regards boards, employees as regards managers) are negligible and that opportunities for misappropriation will be effectively constrained by the nondistribution constraint.

Surely, however, nobody has ever asserted that the nonprofit form suffices, as this statement suggests, to eliminate all but a "negligible" fraction of an organization's overall agency problems. If it did, an efficient economy would consist only of nonprofit firms.

I will return shortly to the factors that I *do* believe explain the variation in nonprofit market share that is not accounted for by the trust hypothesis. But first it is important to consider the areas where the trust hypothesis, even in the strong form (though not the super-strong form), *is* convincing.

DONATIVE VERSUS COMMERCIAL NONPROFITS

In examining the trust hypothesis, Ortmann and Schlesinger focus on commercial nonprofits, and more particularly on the basic human services. They assert, however, that "most of the analysis generalizes readily to donative nonprofits" (1997, p. 3). They offer no support for this generalization beyond a brief footnote that quotes me as follows: "Hansmann (1980, p. 872) argued that 'the distinction ... between commercial and donative nonprofits is simply one of degree, rather than a difference in kind' " (p. 3, note 4). That difference in degree is substantial, however, and correlates strongly with important differences in the degree of asymmetric information, and hence in the efficiency of nonprofit as compared with proprietary firms. As I said immediately following the statement quoted in the first section,

> As a normative justification and positive explanation for the role of nonprofit firms, [the] asymmetric information theory is most obviously convincing when the services involved are either being purchased for third parties or are public goods, as is the case with most donatively supported philanthropies... [Owing to the radical problems of asymmetric information their contributors face], donatively supported organizations are almost universally formed as nonprofit firms. (Hansmann, 1996a, p. 247.)

Indeed, when it comes to nonprofits that are chiefly dependent on donations for their income, and especially organizations that depend heavily on numerous small contributions from dispersed donors, I am prepared to subscribe even to the strong form of the trust hypothesis.[3]

It is important to note, moreover, that many of today's commercial nonprofits had their origins as donative nonprofits that depended crucially on philanthropic support, and initially adopted the nonprofit form because it was essential to attract those donations—that is, to reassure *donors* that their funds would be put to good use rather than simply appropriated—and not to provide assurance to *customers* (such as the patients in hospital) that they would receive care of good quality. This is conspicuously true of nonprofit hospitals, for example, as has often been remarked (e.g., Hansmann, 1980, 1981b, 1996a). The nonprofit status of many of these institutions today can probably best be explained as a matter of institutional lag; though they no longer depend on private or public grants, they have retained their nonprofit form. It is therefore a mistake to seek to explain the nonprofit status of these organizations as a response to problems of asymmetric information facing the paying customers (patients) to whom they provide services today.

In short, what Ortmann and Shlesinger term "the trust hypothesis" can explain the nonprofit form even of many commercial nonprofits that today seem to offer services that are little different in cost or quality from those offered by their proprietary counterparts. One need simply look back in time.

MODELS OF NONPROFIT BEHAVIOR

When Ortmann and Schlesinger say that their analysis of commercial nonprofits "generalizes readily to donative nonprofits," perhaps they have in mind their discussion of what they feel are the gaps in the logic supporting the notion that a nondistribution constraint will reduce the level of opportunistic

behavior exhibited by an organization. Although they do not explore the issue in depth, they suggest briefly that the potential for managerial self-dealing in the form of nonpecuniary benefits may effectively undermine the nondistribution constraint.

Surely there is room for better-articulated models of nonprofit behavior. But the existing models arguably offer more than Ortmann and Shlesinger give them credit for. In particular, work on incentives by Holmstrom and Milgrom (1991, 1994), not cited by Ortmann and Schlesinger, seems to capture reasonably well the role of the nondistribution constraint. As the Holmstrom/Milgrom model illustrates—building on insights offered earlier by Oliver Williamson—there are many circumstances in which high-powered incentives (such as the personal cash compensation tied to organizational profits that is available to the owner of a for-profit firm) may swamp lower powered incentives (such as pride in one's work, altruism, and social shaming) to a degree that inefficiently distorts overall decision-making. In such circumstances, eliminating the high-powered incentives may, on balance, improve efficiency. (See also Hansmann, 1996b, pp. 47–49.) Essentially the same idea is at the heart of the model of nonprofit firms offered recently by Glaeser and Shleifer (2001), which Ortmann and Shlesinger cite only in passing.

EXPLAINING THE PRESENCE OF COMMERCIAL NONPROFITS

The heart of Ortmann and Schlesinger's article, and their most important contribution, is a survey of recent studies that offer evidence on the degree to which consumers do or do not feel that nonprofit firms offer them greater protection from exploitation than do for-profit firms. As they point out, that evidence is ambiguous. But I am not convinced that the authors' suggested program of "more substantial research on consumer expectations and provider motivations" (Ortmann & Schlesinger, 1997, p. 37) will, at least by itself, do much more to confirm or refute the trust hypothesis, much less illuminate the other factors that play an important role in determining the market share of nonprofit firms in different industries. Some of the reasons for this—in particular, the difficulty in interpreting the results of direct studies of trusting and trustworthiness—are explored by the authors. To these reasons I would add several others.

First, even if we knew precisely whether and to what extent commercial nonprofits are—and are perceived to be—less exploitative than for-profit firms in situations of asymmetric information, we would still only have one half of the equation. Before knowing whether nonprofits in fact arise in response to asymmetric information problems, much less whether they are an efficient response, we would have to know the costs of using the nonprofit form, such as decreased cost efficiency. If nonprofits are relatively cost efficient, then even a very modest potential for added trustworthiness may justify, and perhaps cause, their existence. Conversely, if nonprofits are quite poor at minimizing costs, the fact that they are present in markets where asymmetric information is a problem does not tell us that they are on balance an effective response to that problem, or that their presence is not principally the consequence of some other factor.

Second, it may not be consumers who are responding to perceived problems of asymmetric information, but rather regulators. For example, prior to 1973 it was effectively illegal throughout most of the United States to organize a health maintenance organization (HMO) or a hospital as an investor-owned firm, and for about a decade after 1973 federal regulation continued to favor the nonprofit form heavily for HMOs. This regulation was generally rationalized on the basis that for-profit firms could not be trusted by consumers. But it was regulators who were making that decision on behalf of consumers, presumably reflecting the regulators' feeling that consumers could not be trusted to decide how much to trust a for-profit versus a nonprofit firm. Similarly, accreditation of educational institutions has historically been strongly biased toward the nonprofit form, ostensibly for much the same reasons. Of course, this regulatory bias toward the nonprofit form might be understood more realistically as an effort principally to protect the interests of producers, such as doctors and teachers, rather than those of consumers (Hansmann, 1981a, pp. 538–553).

Third, it is often reasonably clear that factors other than trust bear heavily on the market share of nonprofits in particular industries, and it may be far easier to study those factors directly rather than simply relegating them to the error term in a model that, implicitly or explicitly, seeks only to correlate the presence of nonprofits in an industry with problems of asymmetric information in that industry. One conspicuous example is the regulation just mentioned that long prohibited investor-owned firms in important segments of the health care industry. Another example is the phenomenon that I have elsewhere termed "capital embeddedness" (Hansmann, 1996a). This is the tendency of nonprofit firms, once well established, to remain in business—and perhaps grow both absolutely and in market share—even if they are no more, or even less, efficient than their for-profit competitors in all respects, including the quality of service they provide. This phenomenon is arguably important, for example, in explaining why, as remarked above, nonprofit firms have continued to dominate the hospital industry many decades after they ceased to be donatively funded organizations. For an empirical estimate of the importance of this phenomenon in the hospital industry, see Hansmann, Kessler, and McClellan (2001).

CONCLUSION

In short, if Ortmann and Schlesinger are too dismissive of the trust hypothesis with respect to donative nonprofits, they are at the same time more restrained than they need be about the weakness of the trust hypothesis with respect to commercial nonprofits. We have long had good reason to believe that problems of asymmetric information between firms and consumers do not suffice to explain or to justify the large market share of nonprofit firms in the human service industries, which comprise the bulk of the American nonprofit sector today. No one who has much studied the nonprofit sector—myself included—has suggested the contrary. The important task facing scholars is to understand better what *other* factors help explain the presence or absence of nonprofit firms in various industries today, both in the United States and elsewhere, and what public policies might best assure that the nonprofit form is used where, and only where, it has an advantage over alternative ways of organizing production.

NOTES

1. Notably with Arrow and with Nelson and Krashinsky, who are also cited by Ortmann and Shlesinger.
2. As a pointed example, in a 1981 article (Hansmann, 1981b) I argued that the evidence that the nonprofit form in the hospital industry offered an effective response to problems of market failure, such as asymmetric information, was so weak that there was a strong case for eliminating federal and state tax exemption for nonprofit hospitals.
3. Even with respect to donative nonprofits, however, I have not subscribed, and never would subscribe, to the super-strong form.

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Stakeholder Theories