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RESPONSE TO REVIEW ESSAY OF "THE OWNERSHIP OF ENTERPRISE"

Nonprofit Organizations in Perspective

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The editors of *Nonprofit and Voluntary Sector Quarterly* (NVSQ) have generously invited me to respond to the reviews of my book, *The Ownership of Enterprise*, that appeared in the June 1999 issue (Vol. 28, No. 3). I am happy to have the opportunity.

I am extremely grateful to the three authors of those reviews: Peter Hall, Evelyn Brody, and Andreas Ortmann. All are leading scholars of the nonprofit sector within their respective disciplines of history, law, and economics. It is not just an honor, but also very instructive to have them turn their attention so carefully to my work.

All three reviews, and the editors' introductory remarks to them, are so thoughtful and generous as to leave me virtually nothing to complain about and very little to add. Consequently, I will confine myself here to a few reflections that are inspired by their comments, including some thoughts about promising directions for future research.

THE HISTORIAN'S PERSPECTIVE

Peter Hall points out that my interests have never been confined exclusively to the nonprofit sector, and suggests that this has permitted me to bring a broader perspective to the institutions found in that sector. I like to think that this is true. This is perhaps less surprising, however, than the reverse point: Studying the nonprofit sector with care gives one very important insight into institutions outside that sector, including the familiar business corporations that dominate contemporary economic activity. As the authors of all three of these reviews observe, although only one chapter of my book focuses explicitly on nonprofits, the analytic threads that run through the entire book had their origins in my early work on nonprofits. If I had not begun my career

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studying unowned enterprise, I would not have known what questions to ask when I came to examine the various forms of owned enterprise that are the subject of most of the chapters in the book.

Hall takes me gently to task for my “ahistoricism.” I plead guilty to the charge, though only with respect to a scholarly ideal. I like to think that, relative to most work in what we might loosely term organization theory, my own work, including the book in question here, is unusual in the amount of attention it pays to history. I have come to believe that one cannot understand the current patterns of institutional organization in most sectors of the contemporary U.S. economy without a close understanding of the economic forces at play at least as far back as the 19th century, and sometimes considerably earlier. Indeed, I sometimes feel as if my true field of specialization is becoming economic history. But of course, in trying to comprehend the history of institutions, one must necessarily rely heavily on those who are true professionals in the field. In this respect, I should note that Hall’s own work (e.g., Hall, 1984) has been invaluable to me, for example, in the controversial work on endowments that Hall refers to (Hansmann, 1990).

More generally, I believe strongly in the importance of comparative work of every sort. A scholar who seeks to arrive at a deep understanding of the nonprofit sector by confining their attention to nonprofit institutions themselves, and furthermore by examining only those institutions that appear in the U.S. economy today, is likely to be misled. We can only come to understand contemporary nonprofit institutions—and surely we can only test our understanding of those institutions—by comparing them with other institutions or with similar institutions in different settings. History is a critically important source of such comparisons, and one that has not been explored with anywhere near the care that it deserves.

Another invaluable source of comparative perspective in the study of nonprofit institutions, and one that has been developed even less than historical work, lies in cross-national research. The U.S. experience with nonprofit institutions is in some important respects unique, whereas in other respects it is quite ordinary. It is useful not only to recognize this, but more importantly to understand the reasons for both the uniqueness and the ordinariness. Thanks in particular to Salamon and his colleagues, we are now beginning to develop a systematic cross-national perspective on the nonprofit sector at the macro level, with some very useful comparative data on the size and general distribution of nonprofit institutions in a broad range of nations. It remains, however, to probe much more deeply into comparisons at the micro level, in an effort to understand precisely how nonprofit institutions are organized and operated at the level of the firm and industry, and even more importantly to understand why we observe particular differences in these respects from one society to another. Moreover, as Hall would remind us, it is important that we understand the institutional history of these other societies as well.

THE LEGAL SCHOLAR'S PERSPECTIVE

Evelyn Brody, who has the rare virtue of combining the skills and knowledge of a careful scholar of tax law with the broad perspective of an organizational theorist, does a superb job of delineating, and placing in perspective, the main themes of my book. Brody invites me, at the end of her review, to be bolder than I was in the book in making predictions about the ways in which patterns of ownership are likely to change in the future. I find the invitation attractive, and I will try to honor her review by hinting here at a few possibilities for the future.

With respect to the nonprofit sector, in particular, I suspect that very large changes are likely to take place in the decades immediately to come. If we measure the nonprofit sector in terms of GNP, the great bulk of the sector is accounted for by just two industries: health care and education. More particularly, just two types of firms, hospitals and post-secondary schools (colleges and universities), represent much more than half of the nonprofit sector in the United States today. Yet, health care and higher education are both in the midst of rapid institutional change. Although nonprofit hospitals have maintained the dominant share of the hospital industry through several decades of competition from proprietary firms, it seems unlikely that this situation will last. Nonprofit hospitals appear increasingly anachronistic. It seems plausible that over the decades immediately to come, nonprofit hospitals will largely disappear from the scene in the United States. The dominance of nonprofit institutions among nongovernmental colleges and universities will also surely decline over the decades to come, and perhaps precipitously. Proprietary universities are rapidly expanding today. They seem likely to take over a good bit of mass higher education, and perhaps to displace some of the functions of the elite institutions as well. The consequence of these changes alone could lead to an enormous reduction in the size of the U.S. nonprofit sector as measured by GNP. Similar developments in other service industries could lead to even greater reductions.

Does this mean that the nonprofit sector itself is somehow in danger or is likely to become ever less relevant in the modern economy? I think not. As Brody notes, my own view is that the nonprofit form is in part a transitional form that plays a particularly important role in the organization of new industries in which neither the nature of the service itself nor the means of contracting for that service have been standardized to the point where market institutions work well. As these industries mature, they become less dependent on the nonprofit form as a means of organization, though institutional inertia, which is particularly evident in the nonprofit sector, may perpetuate a very large nonprofit presence in these industries for many decades.

The vital presence of nonprofits, however, is in newly emerging industries. It seems to me that there is presently far too little research on these new industries and far too much on the old industries. Whereas we study hospitals to

death, we may fail to see where the real action is. Our society might function very nicely if we were to eliminate nonprofits from the hospital sector, but its progress might be badly affected if nonprofits could not be formed elsewhere. Indeed, if we were to eliminate nonprofits from those areas of health care and education where they are no longer needed, we might free up tremendous resources that could be devoted to building nonprofits in those areas where they would play a more important role. The many billions of dollars that are locked up uselessly in nonprofit hospitals today might be used with great effect in, for example, new forms of communication and the arts.

This means that scholars of the nonprofit sector should be trying to identify the areas in which nonprofits can make their greatest contribution today, and should seek to identify the means by which resources can be directed out of anachronistic nonprofit organizations and into vital ones. Lawyers can play a particularly important role here, as Brody herself has well recognized. We need to find ways to reform nonprofit law to make it easier to convert or liquidate inefficient nonprofit corporations, while assuring that the net assets of those corporations are directed to newer and more vital activities rather than ending up in the hands of their managers, acquirers, or brokers.

The result may be a nonprofit sector that appears smaller but that is accomplishing much more. And indeed this suggests that we need to develop better measures of the nonprofit sector than that provided by the GNP figures alone. How can we quantify more accurately what nonprofits really contribute to our economy and society?

Because *NVSQ* is dedicated particularly to study of the nonprofit sector, I will not expand on likely changes in ownership in other sectors (though I will confirm my belief that Brody is right in suspecting that U.S. law firms will not continue to be organized only as lawyer-owned firms for long; investor ownership will surely invade the field, after the laws preventing it have been swept away in that industry as they have in others). I will say, however, that I like Brody's instincts about interesting topics. In particular, I believe that new organizational forms such as the limited liability company raise intriguing issues. Much of my attention recently has been devoted to developing a more general understanding of the role and structure of the various new and old standard legal forms for organizing enterprise, including nonprofit corporations and limited liability companies, as well as business corporations, cooperatives, municipal corporations, trusts, and even marriage (see Hansmann & Kraakman, 1999).

THE ECONOMIST'S PERSPECTIVE

Andreas Ortmann provides an excellent summary of the book, with a particularly clear identification and exposition of the themes that are most likely to interest an economist. He concludes his review, however, with three caveats. I will say just a few words about each.

First, Ortmann states that he disagrees with the book's strong emphasis on the central role that costs of collective decision making play in determining the patterns of ownership that we observe in modern economies. Because, as he observes, this is the leitmotif of the book, and because I am the author of the book, it is not surprising that I am not convinced by his objections.

Rather, if I had to review my own book, I would point to a different but related problem. Although the book (to my mind) presents overwhelming evidence of the centrality of the costs of collective decision making, it does not illuminate very clearly just what, in particular, the sources of those costs are. Is the principal problem that collective decision making among heterogeneous owners produces decisions that are substantively bad? And, if so, in what ways are decisions commonly biased? Or is the more important problem in the *process* of decision making, with too much time and effort being required to make decisions, whether those decisions are good or bad? And, if the latter, just what kinds of process costs are involved? The macroscopic comparative approach to patterns of ownership that I take in the book does not illuminate these important issues clearly, and theory alone is insufficient to permit us to choose among the various possibilities. It remains for more focused work to provide better answers.

I would also point out another area that could use further exploration. Broadly speaking, there are three ways of making managers responsible to any given group of patrons who transact with a firm: markets, voting control, and what we might call "trusteeship" (by which I mean that the managers are effectively put in the position of trustees, with no direct material incentives one way or the other, and subject only to relatively diffuse norms of responsibility toward the patrons in question). My book, like other work on the theory of the firm, focuses principally on the relative virtues of the first two of these methods. It is time we turned more attention to trusteeship. That approach is used to some extent in all types of ownership, and increasingly so. For example, it is prominently used today in large business corporations that are heavily constrained by law and practice to appoint and give crucial authority to independent directors. But, of course, it is in nonprofit organizations that the trusteeship approach is most strongly employed. Consequently, if we are to enhance our understanding of this form of control, students of nonprofit organizations are in the best position to help us.

Second, Ortmann suggests that I say a few things that are "contrary to common sense." Principal among these is that the quality of lawyers' work is easy to assess. But here Ortmann seems to be mistaking my claim. I am saying that it is relatively easy for the managers of a law firm to assess the quality of their underlings' work, and I stand by that claim. I am not saying, as Ortmann *infers*, that it is easy for the *clients* of a law firm to assess the work that the firm's lawyers do for them. Quite the contrary: It is scandalously hard, at least when the client is an individual and not a firm. (The organized bar, I might note, claims that the legal prohibitions on investor ownership of law firms are an effort to protect consumers from exploitation of this informational disadvantage. But I

am concerned that it is just the reverse: The problem will persist until legal reform permits the formation of investor-owned law firms with a sufficiently broad franchise to develop a meaningful reputation for quality.)

Finally, Ortmann expresses some concern that the book might not represent the state of the art in theoretical work on the organization of the firm. As it is, the book in fact does deal with some of the issues he mentions, and the direct relevance of others to the main themes of the book is not immediately clear to me. In any case, for those who would like some reassurance as to the book's relevance to current theoretical work on the theory of the firm, I am pleased to report that the book has been received favorably by some of the leading scholars in the field (e.g., Holmstrom, 1999), a number of whom have done work explicitly building on the ideas advanced in the book, including Hart and Moore (1998), Kremer (1999), Bolton and Xu (1999), and of particular interest to the readers of *NVSQ*, Glaeser and Shleifer (1999), who develop the first formal models that capture with some generality and clarity the potential efficiencies of nonprofit firms.

I should emphasize, however, that overall I am quite happy with the seriousness and understanding with which Ortmann has approached my book, and I am grateful to him, as to all the reviewers, for such thoughtful treatment.

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