

**THE ECONOMICS OF THE THIRD SECTOR:  
TOWARDS A MORE COMPREHENSIVE APPROACH<sup>1</sup>**

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## *1. Introduction*

Several studies (Salamon and Anheier, 1994; Ciriec, 2000) have documented the growth, during the 80s and the 1990s in the number of Nonprofit Organisations, in their employment share, and in their revenue. In several countries the nonprofit sector outperformed both the public and the private for-profit sector.

Another important aspect of the recent evolution has been the shift of a growing number of old and new nonprofit organisations towards a more productive and entrepreneurial stance. This shift has assumed different patterns in different countries, depending on the role previously played by the sector, its size, and its relationships with the public sector (mainly with the public welfare system).

In the United States, where nonprofit organisations already had an established and recognised productive role, this shift has displayed “a pattern of growing commercialism” (Weisbrod, 1998a). Nonprofits are more actively market oriented and seek out additional revenue sources by, for example, charging user fees on mission-related output, establishing new ancillary activities, and forming joint ventures with for profit companies.

In European countries, the nonprofit sector has traditionally been less developed and recognised, more dependent on public policies, and advocacy oriented. The recent shift has been more towards a stable, continuous and to some extent autonomous production both of social services and of other goods and services with the aim to integrate disadvantaged people into work. These activities are often, albeit not always, financed out of public resources. However, many of the services provided, or the methods of their delivery, are innovative, especially when compared with existing provision, both public and traditional nonprofit.<sup>2</sup>

Many elements of this change in behaviour by nonprofit organisations can be highlighted by comparative analysis, starting with one of the most important of them: the differentiation of legal, institutional and organisational forms.

While the US legal framework has not changed, and differentiation mainly concerns the goals and the degree of the distributional mission<sup>3</sup> of organisations with different ideological commitments and operating in different sectors, in Europe the process has been more complex and profound. Most of the recently-established nonprofit organisations do not take the incorporation form of foundations, or of other non proprietary forms mainly or solely characterised by the distribution constraint; they have instead been incorporated as either associations or co-operatives. Both of these are proprietary organisations, sometimes owned by volunteers, but often by consumers or workers, and the nonprofit distribution constraint is not always their main institutional characteristic.

Traditionally, co-operatives did not engage in the production of social and welfare services, and associations carried out advocacy functions rather than productive activities. The legal status of both institutional forms changed during the 1990s in many European countries so that they could provide social services. Several kinds of “social co-operatives” or “co-operatives for social or collective purposes” were created, and at the same time the productive nature of associations was strengthened.<sup>4</sup> The co-operatives and associations that have now emerged from this process are similar in many respects: co-operatives are guided by more public and less mutual aims, and associations are more entrepreneurial and productive in their behaviour. Compared with traditional non-profits, these new organisations rely much more heavily on the broader representation of stakeholder interests and on participative and democratic management than they do on the traditional nondistribution constraint.

In the light of this differentiation within and among European countries, the simple dichotomy between organisations allowed to distribute profit and those that are not, so widely used in the economic literature, does not suffice to explain the existence, roles and evolution of the nonprofit sector.

A more general theoretical approach is required to understand these new phenomena. This approach should be able to explain the following: the plurality of roles performed by third sector organisations (advocacy for a particular group of citizens or for certain rights; redistribution of resources among individuals, groups, or activities; stable and continuous production of social and collective services); shifts from one role to another, and especially the recent shift towards more productive and entrepreneurial behaviour; and the co-existence of a variety of organisational and legal forms characterised by different goals and constraints.

In our view, this more general approach can be developed by adopting the institutional approach to the study of organisations, but by taking account of suggestions that have been hitherto undervalued, integrating them with non-standard hypotheses on economic agents' behaviour. Full understanding of the third sector and of its recent evolution requires us firstly to abandon an approach that considers, at least in theory, nonprofit organisations as able to compete in every market, and the adoption instead of the more realistic assumption that they are best suited, mainly or solely, to the provision of personal and community care services.<sup>5</sup> Secondly, it requires a more general definition of third sector organisations, one sufficiently flexible to include all their various roles and the diverse institutional features that they assume in different countries. This definition must be based, not on just one simple constraint, but on a more open set of characteristics including declared organisational goals, and the consistency among goals, legal constraints and proprietary structure. Thirdly, it requires us to relax the hypothesis that the economic agents which interact with third sector organisations are by definition self-interested and opportunistic, and to assume instead the hypothesis that agents may have heterogeneous and complex utility functions. In other words, we must shift the focus from the role of the nondistribution or other constraints to the importance of the agents and the behaviour of organisation owners.

Taking account of these three analytical steps, our suggestion is to define third sector organisations as "incentive structures" which use a variety of different incentive mixes to induce the groups of agents involved (donors, volunteers, but

also workers and managers) to behave consistently with the organisational goal. This goal may vary according to the importance of the distributional mission and the specific market failure that the organisation must deal with. The incentive structures of third sector organisations, however, are different from those that prevail not only in for-profit and public providers but also among nonprofit organisations with different goals, proprietary structures and institutional forms.

The paper is organised as follows. The next section shows the shortcomings of theories based on the nonprofit distribution constraint. Section 3 highlights the distinctive features of the markets in which third sector organisations operate. Section 4 analyses the control structure of third sector organisations, while section 5 proposes a view of these organisations as incentive structures. Section 6 devotes specific attention to the incentive structure of third sector organisations controlled by workers and managers, and section 7 describes the characteristics of these organisations. Section 8 concludes.

## *2. Main shortcomings of current explanations of the third sector based on the nonprofit distribution constraint approach*

Since Hansmann's seminal paper (Hansmann, 1980) the economic literature on nonprofit organisations has focused on the nondistribution constraint as formal recognition that no subject is entitled to the residual income of the organisation. The absence of this formal entitlement is remarkable, considering the importance given to this feature in the literature on property rights.<sup>6</sup>

This particular institutional arrangement has been justified by the need to prevent the exploitation of asymmetric information. Since the organisation cannot distribute profits, the owners gain no advantage from exploiting any superior information that they may possess (e.g. on product quality) in order to maximise profit. Consumers are therefore to some extent protected against contractual failure. More generally, non-profits arise when both the costs of contracting and the costs of ownership are too high for some category of patrons (Hansmann, 1996). In this case, defining specific owners for the organisations is inefficient, and the control role is replaced by a fiduciary relationship with the managers. The

latter possess effective control over the organisation, so that 'the non-profit form abandons any benefit of full ownership in favour of stricter fiduciary constraints on managers' (Hansmann 1996: 228). However, it is not always clear what the origin of the fiduciary relationship is, or how it actually takes place, or what factors guarantee that it will be respected. It is implicitly assumed that the nonprofit distribution constraint provides the appropriate incentives for the managers.

The central role attributed to the non-profit distribution constraint has been of great importance for understanding the specificity of third sector organisations. However, at the same time it has reduced the variety of the third sector to a simple set of organisations, namely non-profits foundations or corporations, so that many other not-for-profit organisations in which the owners maintain effective control over the organisation have been neglected.<sup>7</sup> This is the case of many innovative European organisations, like the new associations and co-operatives, the main institutional characteristic of which is not the non-profit distribution constraint.

Moreover, it has been recognized that the importance of the non distribution constraint as a consumer protection device has been exaggerated (Weisbrod, 1998b, pag.72). Indeed, the validity of this claim rests on two main assumptions. The first is that the absence of agents formally entitled to the residual income effectively protects consumers against opportunistic behaviour. The second is that for-profit firms willing to enter the same market as non-profits have neither the ability nor the interest to establish a reputation as non-exploitative of consumers. However, neither of these assumptions seems particularly robust (Ortmann 1996). In fact, the non-profit distribution constraint has proved highly ineffective in preventing the onset of opportunistic behaviour and the exploitation of consumers.

Moreover, this interpretation has focused mostly on the demand side, without analysing the reasons why people set out non-profit organisations. The supply side of non-profit activity has not been thoroughly analysed. Little attempt has been made to interpret the motives that induce entrepreneurs to establish third sector organisations or workers and managers to supply their labour to them - often for relatively low wages - and to behave in accordance with organisational

goals. In other words, attention has focused on the capacity of third sector organisations to cope with failures in the product market, while their ability to remedy failures in the control of managers and workers (agency costs) and the possibility of attracting motivated managers and workers have been neglected.

This theoretical weakness is all the more evident when the theory seeks to explain the differentiation that has recently come about among third sector organisations, and the tendency for a growing number of them to engage in the production and sale of social services to government agencies, or directly to the public. In the case of many of these services, failures in the product market do not seem to be the main obstacle against efficient provision. In fact, both consumers and government agencies are able to exert some control over quality, while for-profit providers can overcome information problems by investing in reputation (Ortmann 1996). Moreover, technological innovation is reducing informational failures in many sectors and enhances rivarly, excludibility and simmetry of information (Ben-Ner, 2001). Indeed, Hansmann himself recognises that his theory is largely a theory of donative non-profits, and he admits that when non-profits produce private goods or services, the problems of asymmetric information 'are inadequate to explain why investor owned firms do not have an even larger market share in these industries than they already do. The non-profit form is a very crude consumer protection device' (Hansmann 1996: 234-235).

A more general approach is needed to overcome these shortcomings in the mainstream theory on nonprofit organisations. However, before outlining this alternative approach, it is advisable to conduct brief analysis of the distinctive features of the sector in which most nonprofits operate.

### *3. The distinctive features of personal and collective services and the role of nonprofit organisations*

The sector of personal and community care services is everywhere characterised by a persistent gap between needs and paying demand, on the one hand, and between needs and supply on the other. Moreover, private demand

often falls short of the collectively efficient level because positive externalities are associated with most of these services .

The gap has widened in the last twenty years because the supply has not been able to match - either in quantitative or qualitative terms - the rapidly growing actual and potential demand for many personal and community care services.<sup>8</sup> In other words, the traditional producers of these services have grown increasingly unable to satisfy new and recognised needs arising in society, especially in countries where provision used mainly to be guaranteed by public welfare systems.

The imperfect and asymmetric information between consumers and producer often considered to be the main reason for the existence of nonprofit organisations is not the only nor the main source of these shortcomings. Other reasons must be taken into account.

Firstly, the socially efficient level of production may often not be achieved because, at that level, consumers' capacity to pay is below the price charged by both existing and potential private suppliers. In this case, the efficient level can only be achieved if the provider is able to mobilise private or public resources so that a reduced fee, or none at all, can be charged to consumers. In other words, the organisation, public or private, must be able to mobilise and redistribute resources in favour of the beneficiaries of its services, thereby shifting consumption to the socially efficient level.

Secondly, the socially efficient level of production may not be achieved because a plurality of market, contract and organisational failures make it impossible or excessively costly to organise stable supply to serve existing and willing-to-pay demand. The failure due to informational problems between consumers and provider is only one among many.

Both of these dimensions - income redistribution and market failures – have an important bearing on the existence and recent growth of third sector organisations. We consider them in turn.

Income distribution becomes necessary when endowments of income and abilities prevent part of the population from satisfying needs that society

recognises as essential. The income redistribution necessary to ensure the satisfaction of these basic needs is normally governed by the state. However, even when certain needs are recognised by substantial groups in society, government policies may be unable or unwilling to bring about the desired redistribution of resources. As a consequence, a demand for (Weisbrod, 1988), but also a supply of, nonprofit production may arise. Private individuals or groups of people dissatisfied with current income distribution may take action to change it through organisations based on donations and volunteer work, or ones able to produce at lower costs. The activity of these organisations may take different forms, such as advocacy for more effective government policies, the direct redistribution of wealth, or the production of specific social services to meet the needs of disadvantaged groups. Third sector organisations are active in all these areas, but it seems that in the last twenty years they have developed mainly in the last of them, providing services to groups unable to pay a price that fully covers the costs and with regard to which public authorities are unable or unwilling to intervene. This is the case of many new social services, which a private organisation is able to operate only if its stakeholders accept price discrimination (if they are consumers), or if they agree to provide the necessary financial resources (if they are donors) or production factors (if they are workers or volunteers) free of charge or at a price below market levels.

As regards the market and organisational failures that affect personal and community care services, these all depend on the multidimensional nature of either the service or its provision. Typically, these services comprise qualitative dimensions evaluated differently by different users. This multidimensionality does not *per se* constitute a source of market failure. If it were possible to devise contractual forms specifying the desired level of each dimension of the service, a profit maximising organisation could operate in this market efficiently. A mechanism of this kind, however, is not available if some of the objectives are non-identifiable or non-measurable. In this case, the dimensions that cannot be clearly inserted as constraints in the maximisation problem will inevitably be

ignored or overlooked by the agents who possess effective control over the organisation (Holmström & Milgrom 1991).

The problem of non-verifiability is particularly relevant to services with a high relational component,<sup>9</sup> for which some dimensions are easily verifiable (for example, unit cost or number of clients served), but others less so (for example, the relational effort made by the workers, which may change the nature of the service). In this case the dimensions that cannot easily be monitored and verified by the parties directly involved (producers and consumers), as well as by third parties (also by public authorities contracting-out the provision), are crucial to assessment of the service's quality. Indeed, the quality of the service depends on the (informal) relationship between provider and consumer, and it is therefore particularly hard to measure. This may give rise to relations characterised by asymmetric information of various types, which we shall now discuss.

The first type of information failure, and the one most frequently mentioned in the non-profit literature, is the informational advantage of producers over consumers concerning the service provided (Hansmann, 1980). If consumers are able to pay, but unable efficiently to control the behaviour of producers without incurring substantial costs, they tend to be exploited by profit-maximising producers with an informational advantage. Third sector organisations may be less willing to exploit consumers because they cannot distribute profits (Hansmann, 1980) or because they involve consumers or volunteers in their management and control (Ben-Ner, Van Hoomissen, 1991). These institutional characteristics reduce consumer exploitation, so that third sector organisations may thus help reduce these contracting costs and increase the service supply.

A second type of information failure in the social services sector is the informational advantage possessed by consumers with regard to their willingness to pay for the services that they desire. This gives rise to the well-known 'free-rider' problem and to high costs for entrepreneurs willing to organise new supply units. Third sector organisations may attenuate this problem insofar as they induce consumers to reveal their true preferences and allow for price discrimination. Some authors have shown that co-operatives and other third sector organisations

may help overcome the free-rider problem (Grillo 1989; Bilodeau & Slivinski 1994). Ben-Ner (1986) considers the case in which consumers take control of the organisation, thereby at least partly eliminating the incentive for free riding. In this case the high costs of contracting (due to producer-consumer and consumer-producer asymmetric information) induce substitution of the market institution with an organisation controlled fully or partially by consumers.

A third type of information failure in the production of social services stems from the incompleteness of labour contracts and relates to the costs of ownership. Managers and workers have better information than their principals do on the effort that they put into their work. This applies to any type of production, and generates the much-studied agency relationships within organisations. In the case of personal and community services, however, the problem of effort monitoring is particularly intractable, given the difficulties in organising well-functioning labour relations.<sup>10</sup> It follows that a third sector organisation employing workers and managers interested in the service provided and establishing with them fiduciary relationships may be able to cope efficiently with this problem, reducing the costs of delivery.

The literature on nonprofits has paid differing attention to these three sources of market failure, concentrating on the first and the second, while the latter has to date been largely neglected, with few exceptions.<sup>11</sup> This scant attention contrasts with the results of the numerous empirical studies demonstrating that workers and managers in nonprofits are paid less than their counterparts in public and for-profit organisations; and also with analyses of social services production of which highlight the importance of the relationship between workers and organisation as a determinant of the cost and quality of the services produced. For this reason, the final sections of this paper are devoted mainly to this point in particular, analysing how the institutional features of third sector organisations are able to alleviate the effort-monitoring problem.

#### *4. The allocation of control rights in third sector organisations*

There are obvious interactions between the distinctive features of the personal and community care sector outlined in the previous section and the differentiation of the nonprofit sector described in the introduction. Since the simple distinction made among institutional forms by considering the nondistribution constraint alone does not seem satisfactory, more thorough use of the tools offered by institutional theory is necessary. Attention must focus on the patterns assumed by the allocation of control rights within organisations, which, in fact, is no less important than the destination of residual income in explaining both the existence and differentiation of third sector organisations. It is so because one of the control rights assigned to the agents entitled to exercise them is the crucial right to determine the goals of the organisation. This right is exercised through ultimate control over all contractual relationships and consequently influences also the incentive system within organisations and thus their internal structure.

When analysing the role played by the control right, it should be borne in mind that many third sector organisations do not possess clear-cut mechanisms with which to define the subject entitled to control rights, and consequently to determine their objectives (in this they differ from for-profit organisations, where it is the contribution of risk capital that matters).<sup>12</sup> However, the absence of predetermined control right assignment does not imply the absence of a control structure (for a different view, see Alchian & Demsetz 1972; Hansmann 1996); this simply has a different, and potentially more variable, characterisation than for-profit organisation.

As a consequence, one cannot expect third sector organisations to display the same type of control as observed when the residual income claimants are fully and formally identified. This is not only due to the institutional mechanisms devised by the organisation; it also relates to the fact that the organisation's objectives are not as clear and well established as they are in its for-profit

counterpart. On the one hand, the separation of rights of control from rights over residual income strongly suggests that the for-profit motive does not figure importantly among the organisation's formal objectives.<sup>13</sup> On the other hand, the alternative formal objectives cannot be stated independently of the conditions that characterise the market in which the organisation operates.

Extending a line of reasoning applied to government institutions (Tirole 1994) to third sector organisations, it is likely that the profit maximisation objective will be substituted, not by a single, alternative goal for the organisation but by a plurality of potentially conflicting objectives. These objectives are often intrinsically very difficult to quantify and codify, because they concern qualitative dimensions of the activity, the translation of which into precise guidelines is extremely difficult. A related problem is that, even when the objectives can be identified, it is difficult to weigh them in order to obtain a stable and well-defined objective function to maximise.<sup>14</sup>

In third sector organisations, identification of the controlling stakeholders can be interpreted as a consequence of the type of redistributive goals and of organisational and market failures that characterise the production of a specific good or service. Third sector organisations are thus highly complex and diverse and the variety of systems for the allocation of control rights simply reflects the differentiation of the third sector. Consequently, it is difficult, and sometimes simplistic, to apply a single organisational model when seeking to explain them. The degree of effective control and the category of patrons controlling the organisation may vary according to the type of organisation. Goals and objectives are not always clearly codified even within organisations, and stem instead from the history of the organisation and the shared values of its stakeholders. The patterns of allocation of control rights, together with a consistent governance structure, are of particular importance in productive and entrepreneurial third sector organisations, given the amount of potential conflict that may arise between the objectives related to the production process and those related to the distribution of the benefits that it generates. At the same time, the allocation of control rights is the main institutional instrument with which the entrepreneurial

third sector organisation can build an incentive structure within the organisation consistent with its objectives.

The literature has already recognised this feature, but mainly with reference to single organisational forms. For example, some authors stress the role of donors as the providers of financial resources in donative non-profit organisations, and thus justify their entitlement to exercise the residual rights of control (Fama & Jensen 1983); others argue that there is no clear-cut way to identify who is entitled to control rights, and the allocation follows informal patterns (Ben-Ner, Montias & Neuberger 1993); while Ben-Ner and van Hoomissen (1991), when discussing mainly consumer co-operatives or consumer associations, simply entrust consumers with ultimate control rights. Often, especially among the new third sector organisations, control rights are efficiently entrusted to more than one category of stakeholders (Borzaga & Mittone 1997). Control over the organisation and over the definition of its objectives gives these stakeholders an incentive to establish and efficiently manage the organisation in pursuit of its chosen objectives.

The analysis may now usefully proceed by linking all these suggestions together and defining the nonprofit organisation more comprehensively as an incentive structure which comprises both constraints and assignments of control rights consistent with the specific problems it has or is designated to face.

##### *5. Third nonprofit organisations as incentive structures*

An incentive structure can be defined as a mix of constraints and rewards offered to the relevant stakeholders of the organisation. Constraints can be established by law and differ according to the legal form adopted, or they can be voluntarily determined by the organisation itself. Rewards may be of different kinds, economic and non economic, monetary and non monetary. The allocation of control rights assumes great importance when defining the incentive structure of any organisation, but especially that of a third sector organisation. The stakeholders who possess the control rights have the power to define both the

organisational goals and the appropriate mix of incentives with which to achieve them. At the same time, the power of determining organisational goals can be perceived as an incentive in itself. In other words there is a close link between the allocation of control rights and the design of the incentive structure within each organisation.

However, there are limits to the powers of the controlling stakeholders. The incorporation form can be chosen from a limited menu of available forms when the organisation is founded, and it is very often taken as given thereafter. Production choices and market specific characteristics also restrict the scope for organisational flexibility.

In our view, both the allocation of control rights and the incentive structure of third sector organisations can be fruitfully explained in the light of the two main difficulties that arise in the production of social and collective services: the need to mobilise resources for redistribution and the presence of market and organisational failures. The varying significance of these difficulties in different markets is a powerful tool with which to explain organisational differentiation within the third sector.

When the redistributive component is substantial, and a nonprofit organisation need a high level of support in the form of donations and volunteer labour, control rights tend to be allocated mainly to volunteers or donors. In some situations, when donors cannot easily control the use of donations, control rights can be efficiently allocated to trustees or local community representatives. The incentive structure of these organisations is designed to enhance the loyalty of donors and volunteers; the nondistribution constraint often plays a decisive role in designing this incentive structure.

By contrast, when the activity does not involve a redistributive component, either because there is a paying demand for the service or because the public authority fully subsidises the organisation, control rights tend to be allocated in order to cope with the market and organisational failures characteristic of personal and community care services. In this case, control of the organisation can be efficiently assigned to consumers when some internal

redistribution is needed (Ben-Ner, Van Hoomissen, 1991), or to workers and managers when it is important that they share the organisational mission. The design of internal incentive structures is aimed at reducing the risk arising from information asymmetry that consumers, workers or managers behave opportunistically.

However, most third sector organisations directly engaged in services provision, as well as many of the new organisations established in recent years, combine a redistributive aim with the necessity to cope with market and organisational failure. This is the case, for example, of organisations serving both people with a paying demand and people unable to pay, but not subsidised by public authorities, or of organisations which seek to improve the income distribution performed by the public welfare authorities providing services for free or at a price which does not cover production costs. These organisations are able to operate efficiently if they implement incentive structures able both to reduce contractual costs and to guarantee the essential resources from a mix of different sources: public subsidies or contracts, donations, voluntary work, but also “labour donations” from workers and managers. Indeed, in these organisations, workers and managers are often asked to share the redistributive aim, receiving monetary compensations lower than those they would receive for comparable tasks in other, notably public, organisations. Two different reasons can explain this behaviour: workers and managers accept a partial redistribution of resources from labour suppliers to consumers (as often happens when paid people work together with volunteers), or they are interested in non-monetary intrinsic or extrinsic rewards. To balance their two aims, these organisations need to design incentive structures consistent with both their appropriate resource mix and the contractual failure that they have to face. As a consequence, control rights in these organisations are often allocated not to a single group of stakeholders, but to a plurality of them, as workers and volunteers, workers and consumers, workers and donors.

The picture of the third sector arising from these considerations is quite complex and dynamic, as the history and the recent evolution of third sector organisations testify. It emphasises that nonprofit organisations are designed not

only to face market failures but also to change income distribution. Nonprofit organisations often combine, in various forms, an attempt to overcome market failures with a distributive aim. Moreover, the suggested subdivision of third sector organisation aids interpretation of the ongoing differentiation process: most organisations can indeed move from one dimension to another, especially from a more donative stance to a mixed characterisation following changes in the political, social and economic environment.

However, since both organisations characterised solely or mainly by redistributive aims and those controlled by consumers and users have been already analysed by the literature on non-profit organisations,<sup>15</sup> the next sections are devoted in particular to the ability of third sector organisations to mitigate the negative consequences of failures in workers' contractual relations and to induce them to accept the redistribution of part of the value that they create. Consequently, particular attention will be paid to organisations controlled, at least partially, by workers and managers themselves.

#### *6. Incentive structures of third sector organisations and workers behaviour*

A first problem arises in the provision of social and community care services from their non-standardised nature. An absence of standardisation implies difficulties in workers' effort monitoring and in the use of traditional contractual instruments. Linking workers' remuneration to their performance does not help solve agency problems within the organisation because of the difficulties of monitoring effort. Consequently, incentives in the organisations producing these services tend to be low-powered, independently of the organisational form.

One consequence of low-powered incentives is that agents have limited motivation to behave efficiently. Since their remuneration is only loosely related to performance, contracts based on monetary incentives trigger low commitment by workers. Opportunistic behaviour may affect output in such a way that

production costs become unsustainable for both private consumers and public welfare authorities.

These problems become more acute when the organisation requires a redistributive commitment in favour of its clients, as happens when the price determined by public or private demand for the services does not cover their cost. In this instance, the organisation must be able to mobilise human and financial resources and to select workers willing to exert effort not only in exchange for monetary compensation.

In fact, several empirical studies have shown that third sector organisations tend to pay their workers and managers less than public and, often, for-profit organisations. Studies of the economy as a whole (Marvis and Hackett, 1983) or of groups of professional workers (Preston, 1990) confirm that nonprofits tend to have the lowest wage levels. The differences in monetary compensations diminish or disappear when research considers industries with a substantial concentration of nonprofit organisations like social, health or educational services (Ruhm and Borkosky, 2000; Borzaga, 2000) or refer only to private organisations (Mocan and Viola, 1997). Some of these studies (Almond and Kendall, 2001) show that nonprofit organisations sometimes remunerate their workers and managers less than public entities but more than their for-profit counterparts. However, nonprofit organisations with a large presence of volunteers, and probably with a high social and redistributive aims, seem to pay lower wages than do other nonprofits, asking for more labour donations (Almond and Kendall, 2000). Moreover, Borzaga (2000) demonstrates that also the differences between the wages of nonprofit and public organisations tend to reduce after some year of tenure.

However, research which also considers job satisfaction establishes that differences in remuneration do not affect the level of job satisfaction (Preston, 1990; Borzaga 2000). Nonprofit workers generally declare higher levels of job satisfaction than for-profit and public employees.<sup>16</sup> As a consequence, workers in nonprofit organisations are less prone to leave them (Borzaga, 2000).

A possible interpretation of these empirical results is that third sector organisations tend to use a peculiar mix of monetary and non-monetary

components in a remuneration package in which the wage component is less substantial than it is in the case of for-profit and public organisations operating in the same industries. The monetary dimension is not the only, or even the main, dimension of the exchange either for the agents or for the principal. In other words, third sector organisations seem able to motivate workers by using non-wage incentives. These incentives are of different kinds. Some tend to satisfy extrinsic motivations, as in the case of training possibilities and job flexibility. Others tend to match intrinsic motivations, such as the relational climate<sup>17</sup> and the social benefits that the organisation generates.<sup>18</sup>

Of course, the demand for labour expressed by third sector organisations can find a matching supply only if there are workers willing to exchange extrinsic (wage related) rewards for intrinsic motivations. Theoretical (Akerlof, 1982; Handy and Katz, 1998; Preston, 1989), experimental (Frey 1997) as well as empirical evidence suggests that this is often the case. Akerlof and Preston demonstrate that the workers' utility function can be positively influenced by their intrinsic motivations, especially by the external benefits generated by the employer. Handy and Katz show that the problem of effort control can be limited or eliminated by selecting motivated managers and workers, or by an auto-selection by the workers themselves promoted by incentive structures which rely less on monetary rewards. Frey tests the importance of intrinsic motivations for economic activities and criticises the exclusive reliance on monetary incentives by modern economics, suggesting that external motivations may crowd out intrinsic motivations and cause a loss of efficiency. Commenting on the results of his research, Marvis (1992) states that workers in nonprofit organisations show greater sensitivity to the social outcomes of their work. They seem to accept lower monetary compensations and agree to donate labour because they are concerned with the social relevance of the organisational output, but also in sharing the mission of the organisation. A recent empirical study on employment conditions in the Italian social services sector (Borzaga, 2000) shows that a large majority of workers in social co-operatives and other associations have chosen organisation and sector of activity on the basis of a specific interest in the content of the job.

Conversely, a lack of alternatives to the chosen occupation or prospects of attractive monetary rewards do not seem to explain organisational choice.

Another important empirical finding concerns the ability of third sector organisations positively to influence worker satisfaction by establishing wage structures which are, and are perceived to be, fairer than those in for-profit and public organisations. “This is true both across the board, within detailed occupations and industries, and along the lines of race and gender wage differences” (Leete, 2000, pag.439). When the perceived fairness is taken into account, it explains on its own almost all the positive differences in job satisfaction between nonprofits and other organisational forms (Solari, 2000).

All these results are consistent with the assumption that nonprofits rely more than other organisations on intrinsic employee motivations and that they design incentive structures able to maintain and develop them. They suggest that the organisational structure of third sector organisations is better able to avert the danger of worker and manager opportunistic behaviour, when compared with for-profit enterprises and public agencies. Moreover they seem able to promote labour donations from their employees. This is so because the organisational structure is able to generate incentive systems consistent with organisational objectives. In particular, the nature of the organisation influences the type of incentive system offered to workers and managers. The choice of a particular institutional form thus signals to stakeholders the kind of objectives that the organisation will pursue, and consequently the incentives that it will offer. As a consequence, the incentive structure of nonprofit organisations seems particularly successful in improving efficiency in the production of personal and community care services.

### *7. Incentive structures and characteristics of third sector organisations*

Instead of the nondistribution constraint alone, several characteristics of third sector organisations are crucial for definition of their incentive structure, and all of them are closely related to their social dimension. Particularly relevant are: the existence of an explicit social aim to serve the community or part of it; the

direct involvement of a group of people belonging to the community or sharing common needs; participation and democratic management. These characteristics are closely related. We will consider them in turn, highlighting their common features.

The existence of an explicit social aim is an important signal of the organisation's nature for both workers and other stakeholders, and also for the outside world. As a consequence, both existing and potential workers and volunteers are able to measure their abilities and expectations against the organisational goals that they will be asked to pursue. This can be seen, for example, in co-operatives and associations whose aim is to create employment or to provide on-the-job training to disadvantaged people. Current and prospective non-disadvantaged workers are made aware of the fact that part of the added value they produce within the organisation will be used to reward disadvantaged workers, and to improve their human capital. It is also evident in social services production, where the organisations commit the profits realised to favouring the development of new activities or increasing the number of beneficiaries. Moreover, explicit social goals and monetary objectives are to a large extent mutually exclusive. A clear signal that no monetary objectives are pursued seems to be consistent with the production of services with non-measurable or non-verifiable dimensions. As noted above, contracts for the production of such services tend to be low-powered, and remuneration unrelated to observable performance.

The requirement that the agents interested in the services provided by the organisation (volunteers, users and workers) should have been involved in their activities creates trust relations, and strengthens and gives credibility to the goals of the enterprise. Indeed, the opportunistic risk related to low powered incentives can be at least partially averted if the objectives of the organisation and those possessing control rights coincide to some extent. In general, the higher degree of freedom for workers to determine the content of the work awarded through low powered incentives can be used to achieve personal objectives different from monetary profit (although not necessarily coincident with the institutional

objectives of the organisation). However, the direct involvement of other stakeholders more interested in achieving the social goals of the organisation greatly reduces this risk. Cohesiveness within the group carrying out the activity also increases the degree of awareness of, and control over, the effort exerted by fellow workers. This is especially important when goals have multiple dimensions.

Participation and democratic management are other salient characteristics of new third sector organisations, and they are consistent with the features discussed above. They are consistent in particular with the need for constant involvement of workers and managers in affirming and defining the goals of the organisation, and also with the representation and participation of other stakeholders, such as clients and customers. Moreover, worker participation and democratic management help establish a wage schedule that is, or is perceived to be, fairer than in public and for-profit organisations, and this improves job satisfaction. A democratic structure does not sharply differentiate between hierarchical levels when it comes to deciding monetary remuneration. This also seems to correspond with the lower importance of monetary dimensions in new third sector organisations, and it is consistent with the use of low-powered contracts. If contractual relations are necessarily loosely defined, democratic and open management has the important role of redirecting strategies so that they are consistent with organisational goals.

Not much needs to be said about limited profit distribution, which should be interpreted in relation to the elements discussed above. We have already noted that the existence of social goals is hardly compatible with profit maximisation. The role of a constraint on profit distribution should therefore be only marginal.<sup>19</sup> In many third sector organisations, the limit on the distribution of profits originated as an institutional choice taken within the organisation, rather than as a characteristic imposed exogenously (by law or by the policy maker). Obviously, monetary variables are still important when running the organisation, for example in guaranteeing its financial strength and its survival in the market (since these organisations face a significant level of economic risk). However, in this case the monetary dimension acts as a constraint (e.g. a certain return must be achieved in

order to reward the capital invested) on the pursuit of the chosen objectives, instead of being a maxim in itself.

While not central to explanation of the role performed by third sector organisations, the limited profit distribution criterion is still important, for two main reasons. Firstly, it is a powerful, albeit partial, signal to stakeholders and the outside world of the organisation's real objectives. Secondly, it restricts the possibility that other, profit-maximising organisations will label themselves third sector organisations in order to obtain unwarranted fiscal and reputational advantages. Clearly, this also applies to third sector organisations that initially pursue non-monetary goals but then shift to more traditional profit-oriented behaviour.<sup>20</sup>

The foregoing analysis supports our initial claim that there is a close link between the characteristics of third sector organisations and the goods that they produce. The different types of organisations constituting the third sector emerge as institutional arrangements which seek to reduce the difference between the goals of the organisation as such, and those of the agents that take part in the activity. Insofar as they limit opportunistic behaviour by worker and managers, they are able to restrict the costs of ownership *vis-à-vis* other organisational forms.

Clearly, even if agency problems and opportunistic behaviour may be reduced, they do not disappear completely. As a consequence, third sector organisations offer an organisational model that is at once fragile and unstable. One of the main difficulties faced by third sector organisations is achieving a constant balance among organisational goals, the allocation of control rights, the incentive structure, and the characteristics of the markets in which they operate. This is a daunting task for these organisations, especially because there seems to be a lack of points of reference in managerial theory and experience, and because existing incorporation forms significantly limit the stabilisation of their governance structure.

Moreover, third sector organisations are extremely sensitive to changes in public policy, especially as regards the types of services eligible for public

subsidies. Understandably, they may be negatively affected by a decrease in public support for the production of social services. But this is not the only example of fragility. Even a decision by the public authorities to finance the production of a service previously provided using private resources may require delicate institutional changes, and thus constitute a risk. If the public authority decides to take up the redistributive aspect of a given service, this implies not only contractual change for third sector organisations but also radical change in their organisational arrangements, in the allocation of control rights, and in the incentive structure.

## *8. Conclusions*

In this paper we have proposed an interpretation of third sector organisations as distinctive incentive structures. They constitute organisational forms able to perform well in the production of personal and collective services that cannot be provided so efficiently by for-profit or public organisations, for two main reasons. Firstly, these services may involve market and contractual failures (often related to the relational component of the service). Secondly, a certain degree of redistribution from financiers or producers to consumers may be required for production to take place.

The institutional characteristics of third sector organisations give rise to original incentive systems that help overcome the problems associated with the production of personal and collective services. Particularly relevant, from this point of view, are the explicit social aim, the proximity between producers on the one hand and consumers and the local community on the other, and an internal organisation that values open and democratic management over monetary remuneration for workers' effort.

However, the changing political and economic environment forces third sector organisations to strike a difficult balance among organisational goals, allocation of control rights and incentive structure. The search for this balance

helps explain some of the features and the differentiation patterns recently displayed by third sector organisations in several countries.

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<sup>1</sup> Some of the ideas presented in the paper are taken from a previous work published in Borzaga & Defourny (2000). The paper greatly benefited from comments and suggestions by the members of the EMES network and by the participants at the ISTR Seminar “The Third Sector. An European Perspective” (Trento, Italy, december 2001). Among them the authors want to acknowledge A. Anheier, A. Ben -Ner, J. Defourny, B. Gui, L. Sacconi, D. Young and A. Wagner.

<sup>2</sup> To emphasise this process and define the new organisations, the term “social enterprise” is often used in the European debate (see Borzaga & Defourny, 2001)

<sup>3</sup> A productive nonprofit has a distributional mission when it provides output to consumers who are unable or even unwilling to pay, offsetting costs through reduced profits or wages and donative revenues (see, Weisbod, 1998b and par. 4 of this paper).

<sup>4</sup> Several new laws on associations and co-operatives were introduced in European countries during the ‘90s. The most interesting are probably the Italian law on “social co-operatives” (approved in 1991, which led to the creation of more than 5000 co-operatives) and the French law on “general interest co-operatives” (2001). In both cases the newly-established co-operatives are required to pursue the wider interests of the community and not only those of their members. Moreover, they engage in typical nonprofit activities.

<sup>5</sup> Although some nonprofits have developed in other activities as well, like the credit market, it is evident that they are mainly present in personal and community care services, as shown by several empirical studies conducted both at regional (Ben-Ner & Van Hoomissen, 1993) and national level (see, for example, Istat, 2001).

<sup>6</sup> See, among others Alchian & Demsetz (1972), Fama & Jensen (1983) and Ben-Ner & Jones (1995).

<sup>7</sup> This is the approach taken, for example, by the influential empirical study carried out by Salamon & Anheier (1994), in which the definition of nonprofit is almost exclusively based on the non-profit distribution constraint.

<sup>8</sup> Many studies (see, for example, the national chapters in Borzaga & Defourny, 2000) stress the gap between the emerging needs for personal and collective services and the capacity of existing supply to meet them. For a review of research that has sought to measure unsatisfied demand, see Laville & Gardin (1997). Low employment rates in the personal and collective services sector across Europe stand as indirect proof of the insufficiency of current production (see European Commission, 1999).

<sup>9</sup> Services have a relational component if the direct relation between producers and consumers influences the quality of the service provided. On this point see Gui (1994; 1996), Uhlaner (1989), and Zamagni (1997).

<sup>10</sup> See, for example, Young (1999).

<sup>11</sup> See for example Preston (1989), Handy & Katz (1998) and Weisbrod (1998b).

<sup>12</sup> In investor-owned organisations, the subjects entitled to control rights according to their monetary contribution to the venture – i.e. the owners – define the objectives of the organisation (the maximisation of the expected value of the enterprise), thereby determining the incentives structure – usually based on monetary variables – best able to achieve this objective.

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<sup>13</sup> Note, however, that as a consequence of agency problems, profit distribution may occur even if it is not a formal objective. From this point of view, the distribution of profits within non-profit organisations, when it occurs, will reflect a failure in the internal control activity. The traditional literature, on the contrary, instead considers the distribution of profits to be the realisation of the covert objectives of the organisation stemming from inefficient external controls.

<sup>14</sup> For example, what is the right balance between the level of democracy within an organisation, the level of consumer well-being, and the degree of redistribution to adopt in favour of beneficiaries?

<sup>15</sup> Most of the literature on voluntary organisations and donations and a large part of the economic literature on nonprofit organisations deal with the distributional aim since they mainly analyse donative nonprofit. As regard nonprofit organisations controlled by consumers, a convincing explanation has been presented in Ben-Ner & Van Hoomissen, 1991.

<sup>16</sup> This argument disputes the interpretation of wage moderation in third sector organisations as a consequence of work exploitation

<sup>17</sup> The impact of interpersonal relationships on people satisfaction is analysed in Gui (1999).

<sup>18</sup> An empirical investigation of the different incentives used by the organisations providing social services in Italy is presented in Borzaga (2000).

<sup>19</sup> Strictly speaking, third sector organisations should be subject to the opposite limitation; that is, they should be prevented from maximising monetary losses in order to finance their non-monetary objectives. In reality, no such limit is needed as the credit market already imposes a strict limit on the borrowing capacity of these organisations.

<sup>20</sup> However, it is worth noting that the incorporation forms assumed by third sector organisations do not often allow for change to outright for-profit status (this is the case for example of the Italian social co-operatives).

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