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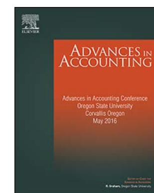

Societal trust and the economic behavior of nonprofit organizations

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ABSTRACT

This study explores the impact of societal trust on the economic behavior of nonprofit organizations. Although prior studies reveal that trust has a positive impact on the economic behavior of for-profit firms, the institutional differences between the two organization types make it unclear whether trust plays a similar role in nonprofits. Our results show that nonprofits operating in higher trust areas are more likely to overspend on administrative expenses. This positive relationship between trust and overspending is primarily driven by service organizations, as opposed to public charities. Moreover, within service organizations, we find that the positive trust-administrative overspending association is most prevalent in situations of weaker monitoring or governance. Additional tests show trust has a similar impact on excess compensation and abnormal accruals in service organizations. Overall, our findings suggest that trust may provide opportunities for nonprofit managers, particularly in service-oriented organizations, to engage in opportunistic behavior that may be exacerbated by weaker forms of oversight.

Why are non-profits so vulnerable? In a word, trust. These organizations are often based on the charity, faith and goodwill of fellow citizens. The organizations strive to create and protect a culture of trust that is oftentimes lacking at for-profit companies, and therefore don't always have the formal set of internal controls in place to guard against fraud that might otherwise be expected.[1]

1. Introduction

Societal generalized trust (hereafter "trust") can serve as a key tool to reduce financial frictions and agency problems. Trust between agents can enhance successful relational exchanges (Morgan & Hunt, 1994). To that end, prior research finds that higher trust is associated with an array of positive outcomes, such as higher levels of earnings quality and greater credibility of earnings news (Pevzner, Xie, & Xin, 2015; Wei & Zhang, 2015) as well as lower levels of corporate misconduct (Dong, Han, Ke, & Chan, 2016). However, an underlying assumption is that trust is usually accompanied by enforcement mechanisms, which are discussed below in further detail (Knechel, Mintchik, Pevzner, & Velury, 2017; Robinson & Robinson, 2015). In the nonprofit setting, enforcement mechanisms are generally weaker than those in the for-profit environment. Therefore, institutional differences between the for-profit and nonprofit settings make it unclear ex-ante whether trust would have a similar impact on nonprofits. Accordingly, we examine the impact of trust on nonprofit managerial opportunism in an attempt to shed light on the role of trust on managerial behavior in the nonprofit setting.

Societal trust can be expected to play a more positive exchange-enhancing role in "repeated game" long-term relationships between agents and principals (Garbarino & Johnson, 1999). In the for-profit setting, shareholders, as residual claimants, have an incentive to monitor and discipline managers for violating trust. Consequently, for-profit managers understand that exploiting trust can lead to long-term consequences of lower stock prices and/or reduced employment (Fama & Jensen, 1983a,b). Thus, shareholders can use the stock market as a disciplining mechanism. In the for-profit setting, external enforcement mechanisms, such as the Securities and Exchange Commission (SEC) and active class-action shareholder litigation, are extra layers of discipline that enforce the principal-agent trust. Therefore, in the for-profit environment, disciplining mechanisms accompany the direct-monitoring relationship between principal and agent.

In the nonprofit environment, the principals are the donors and, unlike shareholders, they are not residual claimants (Desai & Yetman, 2015). Donors are commonly inspired to give because of the "warm glow" surrounding a nonprofit's mission (Andreoni, 1990; Becker, 1974). Since donors do not attempt to preserve their own wealth, their incentives for monitoring nonprofit managers (agents) are generally

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[1] "Preventing Fraud: Tips for Nonprofit Organizations," Cbiz.com, https://www.cbiz.com/insights-resources/details/articleid/1484/preventing-fraud-tips-for-nonprofit-organizations-article (September 20, 2012).

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weaker than those of shareholders. In addition, stringent enforcement mechanisms such as the SEC and shareholder litigation, as well as an equivalent market disciplining mechanism, are largely absent in the nonprofit setting. This relative lack of nonprofit monitoring and enforcement may mean that, compared to their for-profit counterparts, nonprofit managers have less incentive to respect the trust relationship.

Using 93,117 observations of nonprofit entities from the National Center for Charitable Statistics (NCCS) database for the period between 1986 and 2012, we examine the effect of trust on the likelihood of overspending on administrative expenses. Overspending on administrative expenses indicates inefficient resource allocation (Baber, Daniel, & Roberts, 2002; Trussel and Parsons, 2007), which can suggest managerial opportunism. We measure trust as the percentage of people in a given U.S. geographic region who consider themselves to be trusting, according to surveys conducted by the World Values Survey.[2]

Our primary result reveals that nonprofits operating in higher trust areas are *more* likely to overspend on administrative expenses, suggesting that managerial opportunism can prevail in response to high trust. In other words, the institutional make-up of nonprofits enables managers to overspend on administrative expenses in the presence of higher trust. Our main result concerns the average effect among nonprofits. However, nonprofits differ in their mission, operation, and relationship with donors. Accordingly, our results vary by nonprofit type. Though there are a wide variety of nonprofits (Yetman & Yetman, 2012a), a broad distinction can be made based upon whether the donor receives a service from the nonprofit (Hansmann, 1980).

Using this distinction, we examine the effect of trust on two nonprofit categories: service organizations and public charities. Consistent with Kitching, Roberts, and Smith (2012), our public charities category excludes art and culture nonprofits, religious organizations, and nonprofits in the education or medical field. These excluded organizations, where donors receive a service or benefit from the nonprofit, are categorized as service organizations. Donors to service organizations are likely to be actively involved with the nonprofit on a regular basis, which can “build trust and obviate the need for a formal feedback mechanism” (Gordon & Khumawala, 1999, p.48). In such case, these donors resemble consumers. As long as donors are satisfied with their service from the nonprofit, they may be less inclined to monitor (Gordon & Khumawala, 1999). Thus, while donors may trust the service organizations, they also may have less incentive to properly monitor those nonprofits, thereby creating a situation where trust could be exploited.

In public charities, which make up the remaining nonprofit entities, the donor does not receive the service. This creates a clear distinction between donor and service recipient (Balsam & Harris, 2014). Compared with donors to service organizations, donors to public charities are likely to be more reliant on formal mechanisms, such as financial information, to ensure that their donations are properly expended. We find that the association between trust and overspending is driven by service organizations, as opposed to public charities. This is consistent with the view that trust can be exploited in service organizations because of the lack of proper monitoring.

Service organizations appear to overspend on administrative expenses in the presence of higher trust due to a relative lack of monitoring by their donors. As such, we perform additional testing to determine whether the presence of other potential monitoring mechanisms has an impact on this behavior. In the additional cross-sectional tests, we find that service organizations are most likely to overspend on administrative expenses in the presence of high trust when there is *weaker* governance, *less* external monitoring, *less* competition, or *lower* information quality. Overall, we suggest that weaker forms of oversight help enable opportunistic behavior when there is high trust.

In additional analysis, we find that trust is positively associated with abnormal accruals and excess compensation in service organizations. This is consistent with the results of Balsam and Harris (2014), who suggest that service organization donors are less likely to react negatively to the excessive compensation of service organization executives. Overall, this provides support for our main finding of managerial opportunism in the presence of higher trust, which is contrary to what has been observed in “for profit” literature (Hilary & Huang, 2015). Our results are robust to alternate definitions for service organizations and public charities as well as to an industry - adjusted calculation of the trust variable. We also find that the trust-overspending association for service organizations is present only for education and religious organizations.

Our study advances the literature by exploring the association between trust and the economic behavior of managers in the nonprofit sector. To the best of our knowledge, this is the first study to examine and provide an important understanding of the impact of societal trust in the nonprofit sector. By documenting that trust is associated with overspending on administrative expenses, our study suggests that trust plays a different role in the nonprofit setting than in the for-profit environment. Moreover, our study also reveals that trust does not affect all nonprofits in the same way. Specifically, we document that service organizations are more likely to behave opportunistically in high-trust environments than are public charities. Although we attribute this to the potentially different principal-agent relationship in these two nonprofit types, we also note there is variation even among the service organizations. To that end, education and religious institutions were the service organizations most likely to overspend in the presence of high trust. Furthermore, we document that weaker oversight is associated with opportunistic behavior in the presence of higher trust. This suggests that increased monitoring may help reduce a nonprofit's likelihood of overspending when trust is high (Robinson & Robinson, 2015).

Our paper proceeds as follows. Section 2 provides hypothesis development. In Section 3, we describe our research design and sample. Section 4 describes our empirical results and Section 5 concludes with a discussion of our results and future research opportunities.

2. Hypothesis development

Recent research has emphasized the potential benefits of trust in for-profit capital markets. The broad theme of this research is that higher societal trust is associated with lower levels of transaction and agency costs. Higher-trust societies experience stronger economic growth and GDP (Zak & Knack, 2001; Knack and Keifer, 1997), experience lower levels of corruption (Aghion, Algan, Cahuc, & Shleifer, 2010), and have lower levels of earnings management and more credible reported earnings (Nanda & Wysocki, 2013; Pevzner et al., 2015). In addition, higher-trust societies have more efficient trading and more intensive levels of cross-border merger and acquisition activity (Ahern, Daminelli, & Fracassi, 2015) as well as a higher perceived value of financial audits (Knechel et al., 2017).

Although the empirical evidence suggests trust has positive effects on firms' economic behavior in the for-profit environment, it is unclear whether this applies to nonprofits, specifically as it relates to managerial behavior. On the one hand, it is reasonable to suggest that nonprofit managers have incentive to preserve donors' trust just as for-profit managers have reasons to sustain the trust of investors. Because nonprofits rely upon donations, nonprofit managers must work to build trust by faithfully fulfilling their mission and maximizing the welfare of their recipients, instead of maximizing profits (Krishnan, Yetman, & Yetman, 2006). On the other hand, however, institutional differences between the for-profit and nonprofit settings may mean that the benefits for nonprofit managers of violating trust through activities, such as overspending, may outweigh the costs.

In the for-profit setting, investors (principals) are residual claimants and, thus, have a strong incentive to monitor and discipline managers (agents) for violating trust. For-profit managers who exploit trust can be expected to face the long-term consequences of lower stock prices and/

[2] More details on this survey are provided in Section 3.3.

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