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**AN AGENDA FOR NONPROFITS IN THE NEW ECONOMY:  
THEIR ROLE AS INTERMEDIARIES**

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## **An Agenda for Nonprofits in the New Economy: Their Role as Intermediaries**

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### **Introduction**

The term 'new economy' (or 'network economy') refers to an emerging economic world reliant on advanced information technologies of computation and communication. It is characterized by a general trend towards global organizations and marketplaces, a move from tangible to intangible goods, and a leap into an intensely inter-linked network of goods and agents. A deluge of books and articles in the last five years preach, mainly to the converted, that no one can escape the implications of the new economy. Those implications include macro-economic effects, such as faster increases in productivity and greater dependency on technological skills, and also micro-economic effects, such as sharp declines of mass production and of intermediaries between producers and consumers. Such implications require new forms of organizational design and business strategies (e.g., Kelly, 1998; Brown and Duguid, 2000).

We ask here whether the new economy has similar implications for nonprofit organizations. On the one hand, nonprofit organizations have traditionally excelled in facilitating transactions and creating relationships based on their information-related advantages, precisely where government and business fall short. We will consider below, for example, the special role of nonprofits in situations of information asymmetry where consumers with limited information are disadvantaged relative to their suppliers, or in mobilizing resources for public goods where information on consumer preferences is not revealed in the commercial marketplace. The new economy - with its expansion of complex, intangible and collective goods and services - arguably creates a greater need for satisfying these information-related

requirements, and, therefore, broadens the potential scope in which nonprofit organizations can operate. On the other hand, proponents of the new economy claim that widely available technology makes it easier and cheaper to access information and to create and maintain relationships, perhaps enough to render obsolete the information-related advantages of nonprofit organizations. On the face of it, therefore, it would seem that the nonprofit sector faces both new threats and new opportunities that pertain to the very reasons for its existence.

### **Information, Information Technology and the Business Sector**

There is a growing consensus that the Internet has changed the rules of economic life through higher connectivity, greater speed of communication, and a shift from tangible to intangible goods such as ideas, information and relationships (Kelly, 1998). The new rules are changing the organizational models and relative advantages of businesses, particularly those that add value primarily by processing and communicating information. These new rules have impact on two levels: they affect the nature of information flow and the general structure of the market place.

There are three dimensions to the flow of information: “reach”, i.e., the number of people to whom the information is accessible, “richness”, i.e., the depth and detail of the information, and “affiliation”, i.e., whose interests are represented by the source of information (Evans and Wurster, 1999). Thus, these dimensions characterize the target, content and source of the information. The upper half of Table 1 summarizes these three dimensions and how they are changing in the new economy.

Reach. On the supply side, advanced technologies of computation and communication make accessible vast quantities of information. The large number of information sources that are

technically accessible become useful through information intermediaries that collect, filter, evaluate and organize the presentation of data from these sources. For example, smart agents (computer programs) make it possible to find information on the Web, and dedicated websites collect and compare data about goods and services. Both smart agents and websites act as information intermediaries (“infomediaries”). On the demand side, the decline of intermediary organizations (e.g., using the ATM instead of a teller in a bank or using a ticket website instead of a human travel agent) implies that more people are looking for more information individually.

Richness. The ubiquitous use of information and communication technologies creates expectations for richer information about goods and suppliers. In general, complex evaluations and value-laden judgments require richer information. The consumer who uses the Web instead of a travel agent to book a ticket, confronts greater complexity in processing information, which in turn requires richer information to overcome that complexity. For example, products such as clothes can be described in great detail, visualized and shown in reference to the customer’s measurements. Valued opinions are found in communities of practice that share information and recommendations about services, creating a richer description than the traditional set of facts about products. Overall, the move in the new economy from tangible to intangible goods creates a need for more and richer information because of more ambiguous selection criteria.

Affiliation. Faced with an abundance of information and information intermediaries and the need to evaluate relatively complex goods and services, consumers will seek information from sources that they can trust. Hence, they will tend to search for information sources whose affiliations reflect consumer rather than supplier loyalties. For example, consumers seek assurance that an agency for evaluating car safety is not biased by industry interests. Affiliation is most important

when the stakes are very high (e.g., the quality of health providers) or heavily value laden (e.g., advocacy on public policy issues).

The new economy involves some changes in the marketplace that go beyond the supply and demand of information per se (see the lower part of Table 1), namely a structural transformation from the traditional marketplace into a network economy. This transformation introduces external effects that distort competition and potentially influence the efficiency of resource allocation. The most cited effect of the network economy is its law of increasing returns to scale which leads firms to connect to greater and greater numbers of consumers and to absorb additional networks. In particular, increasing numbers of new goods and services consist essentially of information itself, which can be used over and over without degradation. Hence, although information may be expensive to produce, it is inexpensive to reproduce. Companies can therefore provide such new offerings for free, drawing in more customers and increasing the value of their networks with negligible marginal costs.

The net impact of this scale effect on competition and market shares is mixed. On the one hand, information and communication technology reduces barriers to entry, making information relevant to purchasing decisions more accessible and encouraging competition. In addition, as Downes and Mui (1998) argue, information technology reduces transaction costs (i.e., costs of using the marketplace to perform a transaction) and thereby reduces the optimal size of a firm. However, the law of increasing returns for networks creates an advantage for vast companies such as Microsoft and FedEx, Internet companies such as Amazon and eBay, and mergers such as MCI with WorldCom. Although the initial growth of such companies is relatively flat, once they achieve a critical mass of network members, they begin to grow exponentially and eventually threaten to become monopolies. Yet, it is unclear whether this development will

necessarily lead to increased prices or reduced quality, precisely because of the need of these companies to maintain their networks. Nor is it clear whether such monopolies will stifle innovation or use their resources to innovate and stay ahead of competitors. Nonetheless, it would seem that at some stage in the development of network goods, monopolies will emerge, introducing uncertainty and, potentially at least, inefficiencies into the new economy.

An additional effect on market structure is the tendency of “lock-in” between consumers and producers. Setting up electronic connections, either business to consumers (B2C) or business to business (B2B), is an investment that tends to bind the partners as long as the relationship does not go sour. Individual users tend to act as “cognitive misers” - having learned one application they are reluctant to learn another unless they feel that the service to which they are connected has become substantially inferior or obsolete. Like in all business relationships, trust must still be maintained, but in the absence of gross failures it is difficult in the new economy for consumers to shift brand loyalties, thus re-enforcing the tendencies toward monopoly.

The two categories of effects in Table 1 are interrelated. For example, economists generally argue that a competitive market supported by good information helps assure efficient allocation of resources. But that very same information may undermine efficient allocation in the presence of network externalities by precipitating changes in the competitive structure of the marketplace itself (Malinvaud, 1972). Hence, in the business sector at least, changes in the character of information, as experienced in the new economy, have profound effects on the structure and functioning of business firms. We anticipate that the same is true for nonprofits. We examine this proposition next.

## **Nonprofit Theory and Information**

Economic theories intended to explain the existence of nonprofit organizations and their functions in society revolve tightly around the role of information. If this theory is on the mark, it stands to reason that the current revolution in information and communication technologies will influence the expected character and role of nonprofit organizations in the future. The intent of this section is to review key dimensions of nonprofit economic theory and their implications for nonprofits in a regime of increasingly sophisticated information technology. The three dimensions of information (reach, richness and affiliation) help us to compare nonprofits with for-profits. Nonprofits would seem to have no general advantage over for-profits in terms of reach. However, nonprofits are strong on affiliation and, through their closer relationships with consumers, can potentially obtain richer information. This relative advantage will be examined in relation to three classes of demand for nonprofit services: demand for private goods produced by nonprofits, demand for public goods produced by nonprofits, and demand for nonprofit services financed by government (see Table 2).

Demand for Private Goods. Nonprofit organizations supply many goods and services that can also be provided by businesses in the private marketplace. These include day care services for children, education and training, performing arts, and so on. A distinguishing feature of these “private goods” is that they are consumed by individuals who can be excluded from their use unless they pay. The question thus arises in theory - why do nonprofits offer such goods and services if businesses are capable of providing them?

The “contract failure” theory of nonprofits (Hansmann, 1987) argues that the services of nonprofits are demanded where there is an asymmetry of information that puts consumers at a

disadvantage relative to producers. In order to avoid exploitation in this situation, consumers prefer to purchase services from organizations they can trust. Nonprofits are deemed to be more “trustworthy” than for-profits for several possible reasons: (a) because they must adhere to a “non-distribution of profit constraint” that precludes their managers from personally benefiting from extra profits achieved at the expense of consumer interests (Hansmann, 1980), (b) because they are governed by people, e.g. parents of children in day care, whose interests are aligned with consumer interests (Ben-Ner, 1986) or (c) because they attract managers and employees who are motivated by the social mission of the organization (Young, 1983). An essential point here is that nonprofits are said to be higher on affiliation and therefore preferred when consumers are informationally disadvantaged and must seek a trustworthy information source.

Moreover, the network economy has the potential to change the balance between nonprofits and for-profits in the provision of private goods, by altering the relative qualities of information (reach, richness and affiliation) available to consumers and producers. Consider several possibilities. First, advanced information technology has the potential to improve the reach and richness of information available directly to consumers. If parents of young children can get cheap reliable, current information on the character and reputation of alternative day care providers, they presumably would have less need to rely on trust, i.e., on nonprofit status as a proxy for trustworthiness. In services of this nature, for-profits might increase their market share and nonprofits could lose some of their special advantage as trustworthy suppliers. Nevertheless, complex, ambiguous and value-laden judgments, such as subtle differences in service quality or promulgation of moral, religious or political points of view, rely on interpretations of rich information. For such judgments trustworthy intermediaries remain essential, and the stronger affiliation characteristic of nonprofit organizations may gain them a more important role.

Furthermore, information technology could exacerbate consumers' informational disadvantage by increasing the capacity of for-profit suppliers to learn about consumers' needs and preferences and become more aggressive in targeting them in their marketing campaigns. Under this scenario, consumers may worry about losing their privacy and could be overwhelmed by solicitations from a confusing array of reputable and disreputable suppliers among which they may have difficulty differentiating. A few egregious for-profit providers may tar the image of all such suppliers - the lemon effect (Akerlof, 1970). Hence, consumers may choose to withdraw into the safer haven of nonprofit providers.

On the basis of theory alone, it is hard to determine which of these effects will dominate. What is clear is that the issue of distinguishing reliable from unreliable information will become more important in situations where choice is complex and ambiguous, and here an enhanced role for nonprofits may emerge. As intermediary, trustworthy and neutral information suppliers, nonprofits can help consumers process available information in order to choose intelligently among alternative suppliers - profit or nonprofit. This is a role that (nonprofit) industry trade associations and accrediting bodies now play and, to the extent that such agencies can prove their integrity as neutral monitors of their own members, that role may grow in the network economy. Importantly, the new economy may call for more independent nonprofit intermediary bodies, accountable directly to consumers, which can be relied upon to take an objective and critical view of alternative suppliers.

Demand for Public Goods. Public goods have the characteristic of "non-excludability". Once they are provided, it is difficult to exclude people from enjoying their benefits even if they do not pay. Public parks, public safety, conservation of the natural environment, public art, social justice and world peace, all have this characteristic. Nonprofits, according to theory originally

advanced by Weisbrod (1977), have a role in providing public goods because governments are incapable of completely satisfying the demand for them. The basic reason is that individuals' preference for public goods are heterogeneous, while government must largely provide public goods in a uniform way. In a democracy, governments will follow the preferences of the "median voter" or those of a dominant governing coalition. This will leave under-served some citizens who would prefer to pay more taxes for additional public goods, and it will leave others, who would prefer to pay lower taxes and receive a smaller quantity of public goods, unhappy as well. This situation leaves a role for nonprofits - to fill in with additional public goods provided on a voluntary collective basis, and to advocate for changes in government provision. While the latter requires nonprofits to overcome "free riding" (people benefiting from public goods without paying for them), through various fund raising strategies, it provides an important role for these organizations in a variety of fields including policy advocacy, research, public safety, community health, assistance to the poor, and overseas aid.

Information is also central to this aspect of nonprofit theory. The reason that governments cannot charge differential taxes and provide differing levels of service to various groups of citizens or consumers derives from the classical problem of "revealed preferences" (Head, 1990). In short, it is difficult for government to determine how much individual citizens are willing to pay for different levels of service provision, and hence to customize tax schedules and service levels accordingly. The voting process provides only aggregated preference information on multiple services and spending preferences which cannot easily be disentangled, and surveys may not yield truthful responses if citizens believe that the information will be used to charge higher taxes. (They would rather understate their willingness to pay, in the hope that they can free ride on the payments of others.) In summary, public goods present an information

asymmetry problem that is the reverse of that for private goods - in the public goods case, consumers have better information on their own preferences and willingness to pay than government has.

How does the new economy change this picture? First, advanced information technology may make it easier for government to obtain information on local community and individual preferences, so as to enable a degree of customization in public goods and tax schedules not heretofore possible. For example, advanced technology can be employed to collect personalized survey data to help design services for individuals or small groups (Malinvaud, 1972). Alternatively, nonprofits can use information technology and their stronger affiliation characteristics to gain knowledge of the interests and preferences of their donors and consumers, information they need for voluntary provision of collective goods and to overcome the free-rider problem. For example, by determining the kinds of private benefits (unique gifts, recognition, membership services, etc.) potential donors would enjoy, nonprofits can develop better ties between the private benefits they offer and the donations they solicit to support the public goods that they provide. Alternatively, nonprofits can use new fund raising methods such as the “provision point mechanism” to help overcome free rider problems by making provision of a public good contingent on sufficient overall donor support (Marks and Schansberg, 1997)

If the revolution in information technology potentially improves the efficacy of public goods provision by both government and nonprofits, how will it affect the balance between these sources? Will nonprofits’ market share of public goods increase or decrease? Overall, the advantage here would appear to go to nonprofits which are better positioned to offer public goods on a case by case basis for specific groups of citizens and in particular locales. Government, to the contrary, may become more nimble but it can never decentralize itself and

differentiate its tax and service delivery schedules as finely as private, autonomous nonprofits can. Moreover, government already has the capacity to tax in order to overcome free riding; nonprofits, by overcoming some of this disadvantage through improved informational techniques, will diminish government's margin of advantage along this dimension. In addition, the new economy makes it more difficult to collect taxes for several reasons: easier tax evasion on global transactions; diminished taxable revenue due to disintermediation (i.e. elimination of taxable firms and their assets and revenues streams); and technical and legal difficulties in taxing transactions that are initiated, delivered and billed over the Internet. These reasons apply especially to intangible services. All this argues for an increased share for nonprofits in the provision of public goods in the future.

Demand for Government-Financed Services. Many of the services financed by government are ultimately provided by nonprofit organizations under contract or some form of reimbursement. This set of practices is partially explained by Salamon's (1987) theory of third-party government. The theory argues that government is efficient as a financial agent because it can overcome various aspects of "voluntary failure" (including the free rider problem), while nonprofits can be more efficient in actually delivering services because they are more locally responsive and less costly. The practice of government financing coupled with nonprofit delivery is common in several public service domains including social services, health care, and education.

The economic theory of transactions costs is useful for understanding this practice and its relationship to information (Williamson, 1985). Government has two choices to make once it decides to provide a particular good or service: First, should it provide the service itself through a government agency or should the service be contracted out (outsourced) to a private supplier? Second, if the latter option is chosen, should the selected supplier be for-profit or nonprofit?

The first decision depends on the relative transactions costs of internal provision versus contracting out. Internal transactions costs include resources used to identify consumer demand, arrange for delivery, collect fees, and coordinate various departments involved in financing, delivering and evaluating the service. External costs associated with contracting out involve searching out and evaluating the merits of alternative suppliers, negotiating and enforcing contracts, and monitoring contractor performance over time.

The second decision has much in common with the issue of private goods provision discussed earlier. If the government decides to contract out it may experience an information asymmetry problem: potential suppliers may have better information than government and hence can potentially exploit the relationship for private gain. Hence, government may seek “trustworthy” nonprofit suppliers if it feels disadvantaged in this respect. Alternatively, if government is fully capable of acquiring and evaluating the information it needs to oversee contractors, it may prefer to open the competition to all types of suppliers in an effort to get the best possible deal.

How could improvement in information technology affect these relationships? How might it affect the degree to which government decides to contract out, and the degree to which it prefers nonprofit to for-profit suppliers? First, it appears likely that availability of more and richer information would favor more contracting out. While such information would also improve government’s ability to market its own services to citizens directly, it is unlikely to be able to do this better than more nimble private contractors. In addition, most governments already have relatively good knowledge of their internal transactions costs such as interdepartmental coordination, so that enhanced information would probably not provide great benefits along these lines. On the other hand, the network economy is reducing external

transaction costs and putting government in a generally stronger position to shop and make choices among private suppliers.

More and richer information would also appear to favor for-profit over nonprofit contractors. Government normally has the resources to purchase the information it needs and the capacity to evaluate that information. When information richness and reach increase, government becomes better informed and hence takes less risk in choosing a for-profit supplier. Again, it is possible that nonprofits can play an intermediary role as neutral information providers for government purchasers, particularly for smaller, less sophisticated governmental jurisdictions. However, this role seems less compelling than in the case of individually purchased private goods, since governments often have their own substantial evaluative capacities.

Another role that nonprofits can play here, however, is that of watchdog over government contracting practices. Some of the for-profits that become part of the new economy will grow in size and may become monopolies, introducing potential inefficiencies. Moreover, as contracting expands, the opportunities for corruption also increase. For-profit contractors in particular have an incentive to buy the favor of public officials in order to secure lucrative projects or programs. Again, neutral nonprofits with strong affiliation to citizens and communities have the potential for protecting public interests by monitoring these situations.

### **Implications for Research and Practice**

Analysis of the economic theory of nonprofits reveals areas of activity where the role of nonprofit organizations may be either diminished or enhanced by improved information technology in the new economy. Table 3 summarizes our main predictions of the effect of the

network economy on the relative market shares of nonprofit organizations for each category of service. These predictions remain hypothetical. More specific empirical research, targeted to particular areas of service, is needed. Such research might employ a comparative time series design in which the changing informational character of services in different industries is compared and juxtaposed against changes in nonprofit market shares in those industries over time.

Research is also needed on how information technology can be designed and utilized to leverage the relative advantages of nonprofits. Foremost is the question of how information technology can be used to help build relationships and enhance trust with large numbers of members.

Secondly, how can information technology be designed to capitalize on enhanced relations and a sense of community to generate rich information, and how can this information be utilized without compromising trust? Finally, how can relationships and rich information be used to provide computer-based customized services, e.g., smart agents that 'know' the member and can personalize service packages, such as legal advice or a visit to the local museum? These kinds of questions can best be studied through systematic identification, documentation and analysis of case studies of innovations introduced by nonprofits in various segments of the economy as they seek to adapt their operations to the information age.

There are also immediate practical implications of our analysis. Perhaps the most obvious one is that nonprofits must become major players in the new network economy. Currently, it is probably still fair to say that a relatively small proportion of nonprofit organizations employ advanced information and communications technology for facilitating relationships among organizations and groups of citizens and consumers (Burt and Taylor, 2000; Pew Partnership for Civic Change, 2000). The first step is for nonprofits to become intimately

acquainted with the technologies and to experience first hand the network economy at work. With that experience will come a reframing of their missions and strategies in order to capitalize on the particular strengths summarized in Table 3. Perhaps most importantly, nonprofits need to further develop themselves in their roles as trusted intermediaries. For example, they will need to consider new ways of becoming more intimately affiliated with, and accountable to, the people they serve if they are to be able to bring consumers and suppliers together on a virtual basis. They will have to learn to be particularly effective in ambiguous, complex and value-laden contexts, where they are most needed. At the same time, nonprofits will also have to determine the limits to the use of technology. For example, clergy's intuitive reluctance to use computers for organizing private information of congregation members (Berlinger and Te'eni, 1999) reflects a realization of how affiliation and trust in some domains of life are still governed by norms established in the old economy. An important strength of nonprofits is that they are well positioned to be alert to traditional sensitivities as they address the new challenges of the information age.

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**Table 1: Effects of the new economy on information and market**

<b>Effect on information</b>	<b>Explanation</b>
1. More accessible information and information intermediaries provided and needed	Information and communication technologies increase information supply. Disintermediation increases demand. These effects lead to increased need for information intermediaries (infomediaries).
2. Richer information needed	Consumer expectations and need to cope with higher ambiguity call for richer information.
3. More trusted information needed	Abundance of information sources and complexity drive consumers to seek trusted sources.
<b>Effect on the new market place</b>	
1. Network externalities increase rapidly with the number of members in the network	Strong incentives offered to join the network. Information products complement free tangible products.
2. Monopolies may develop as a result of network economies	Possible losses in efficiency due to monopolistic practices
3. Lock-in effects between consumers and producers	Consumers become “cognitive misers”. Building long term relationships and trust is essential.

**Table 2: The roles of nonprofits**

<b>Category</b>	<b>Definition of category</b>	<b>Rationale for role of nonprofits</b>
Private goods	Consumers can be excluded from the use of private goods unless they pay, e.g., nursing home.	In situations of information asymmetry between consumers and suppliers, the less informed consumers trust nonprofit organizations.
Public goods	Consumers cannot be excluded from enjoying the benefits of public goods once they are made available, e.g., public art.	In situations of heterogeneous preferences and information asymmetry between consumers and government, nonprofit organizations provide public goods on a voluntary basis.
Government financed services	Nonprofit organizations provide goods financed by the government, e.g., social services.	In situations of heterogeneous needs and information asymmetry between consumers and government, and between government and private suppliers, government relies on nonprofit organizations as trustworthy agents to provide locally responsive services or to oversee other suppliers.

**Table 3: The effects of the new economy on nonprofits**

<b>Category</b>	<b>Predicted effect of new economy on the role of nonprofits</b>
Private goods	Diminished role in informing consumers when criteria for choice are clear. Greater role in informing consumers when criteria for choice are ambiguous.
Public goods	Greater role in providing customized services.
Government financed services	Diminished role in providing public services. Greater role in overseeing government contracting practices.