

**THE NEW THEORY OF GOVERNMENT-NONPROFIT
PARTNERSHIP: A HAYEKIAN CRITIQUE OF THE SALAMON
PARADIGM**

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THE NEW THEORY OF GOVERNMENT-NONPROFIT PARTNERSHIP: A HAYEKIAN CRITIQUE OF THE SALAMON PARADIGM

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ABSTRACT

Lester Salamon in a series of papers and books has argued that traditional explanations of nonprofit organization are flawed. Nonprofit organizations do not exist as a substitute for services provided by government, but instead exist in partnership with government to form a “third party government”. Salamon contends that we have failed to see these institutional linkages because of faulty economic theory. In contrast we show that Salamon’s work reveals a lack of conceptual clarity on basic issues in economics, and as a result he is led to advocate a policy stance which if pursued would result in an ineffective independent sector.

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Introduction

Nonprofit organizations have traditionally been considered a substitute for the services provided by the bureaucratic welfare state (Berger, Neuhaus, and Novak, 1996). Lester Salamon’s body of work – which is extensive – suggests otherwise.¹ Salamon argues that the U.S. has a long, established history of efficient institutional linkages between the nonprofit sector, which he calls the “voluntary sector,” and the state. Rather than a substitute, Salamon sees nonprofits in an effective “partnership” with the state, a form of “third party” governance.

¹ See, for example, Salamon (1981, 1987, 1989, 1992, 1993, 1995, 1999), Salamon and Abramson (1982) and Salamon and Anheier (1996a, 1996b). We will pay special attention to Salamon (1987), as it provides the clearest discussion of his own theory of government-nonprofit partnership, one which continues to influence his recent work.

Salamon's work attempts to show not only how the nonprofit sector can support and improve the modern welfare state, but more importantly, how the welfare state supports and effectuates the nonprofit sector. Much of the postcommunist literature, having witnessed the collapse of real-existing socialism, has turned not toward free and open markets, but instead toward the market-based welfare state, as witnessed by the work of Joseph Stiglitz (1994) among others.² Salamon's work keenly anticipates this postcommunist justification of the state, in his advocacy of "third-party government." To him, the evolution of "third-party government" was misinterpreted, or worse, outright ignored, due largely to defective *economic theory*. Salamon argues that

The widespread neglect of the massive growth of government-nonprofit relationships that characterized the 1960s and 1970s was a product not simply of a lack of research but, more fundamentally, of a weakness of theory. Both the theory of the welfare state and the theory of the voluntary sector were deficient, moreover – the former because of its failure to acknowledge the reality of "third-party government" and the latter because of a view of the voluntary sector that emphasized its role as a substitute for the state. Neither perspective left much room for a flourishing government-nonprofit partnership. To come to terms with the reality of widespread government-nonprofit cooperation, therefore, it is necessary to reshape the conceptual lenses through which this reality is perceived, to replace traditional theories of the welfare state with the concept of "third-party government," and to replace prevailing "market failure/government failure"

² See Prychitko (1990, 2002a) for a criticism of the welfare state alternative, and Boettke (1993, 2001) for a criticism of post-communist policies in general.

theories of the nonprofit sector with a theory that acknowledges the possibility of “voluntary failure” as well, of inherent limitations of the voluntary sector. Equipped with this alternative set of theoretical lenses, the widespread partnership between government and the nonprofit sector comes into focus not as an aberration, but as a reasonable adaptation to the respective strengths and weaknesses of the voluntary sector and the state. Rather than a phenomenon to be shunned or discouraged, cooperation between government and the voluntary sector emerges from this analysis as a reasonable model to be promoted and improved (1995, p. 6).

Salamon believes his theory provides a new “paradigm” – in the Kuhnian sense (1987, p. 36; cf. Salamon and Anheier 1996b, pp. 1-7, 119-123) – to explain the evolution of the government-nonprofit partnership, and justify and promote its continued development.

Although the present authors do not share Salamon’s ideological project, our paper has a different focus.³ Rather than engage in an argument over competing ideological visions, we wish instead to examine Salamon’s paradigmatic *theory*. He attempts to engage in a theoretical reconstruction of economic analysis -- specifically the notions of market failure and government failure – and adds to that his new notion of

³ Salamon advances the normative claim that “cooperation between government and the nonprofit sector makes a great deal of sense both conceptually and practically. These two massive sets of institutions share many of the same basic objectives and have strengths and weaknesses that are mirror images of each other. Under the circumstances, the recent efforts [i.e., the Reagan reforms] to dismantle or significantly curtail, this partnership seem singularly ill advised even if they are largely unintended. A more sensible approach would be to find ways to make this partnership truly work, not only for the “partners” but also for those being served.... The chapters presented in this book were originally written with this end in view.... Now the challenge is to build on that start and set in motion a more basic effort to make government and the nonprofit sector not merely interconnected sets of institutions but true “partners in public service” (1995, pp. 12-13). We applaud Salamon for at least making his ideological program explicit. Our own ideological vision differs, as we prefer both a robust and open market and nonprofit sector, and a substantial limitation on the powers of state compulsion.

“voluntary failure.” Salamon argues that the (few) economists who have studied the nonprofit sector (most notably, Weisbrod [1977, 1988]) view the complex interconnections between markets, nonprofits, and the state with the wrong theoretical lenses.⁴ In this literature, nonprofit and philanthropic organizations emerge in response to both market failures (due to free rider problems) and government failures (due to programs being devised which meet the demands of the “majority” of constituents and thereby leave the demands of others left unmet).

Burton Weisbrod’s thesis (1988, pp. 16-42) is a fairly conventional application of market and government failure analysis to explain the existence – and persistence – of nonprofits in a generally free market system. In short, Weisbrod argues that markets are generally efficient; but in specific cases, particularly the production of public goods, the free market alone cannot be expected to generate socially efficient outcomes. Theoretically, at least, government intervention can be used to influence and improve upon (in the sense of generating an optimal or socially efficient result) through its coercive powers to tax free riders – that is, to force those who would enjoy consuming a public good, but have little or no incentive to voluntarily pay to obtain the good. Weisbrod suggests that government intervention in this way tends to work well when consumer demand is homogeneous. In principle, it is a straightforward exercise to determine who gains from the production of a public good (think of, for example, the common textbook case of national defense), to tax them appropriately, and use those tax revenues to subsidize the production of the public good. On the other hand, when consumer demand is heterogeneous, or diverse, the task becomes much more complex.

⁴ Salamon seems unaware of Boulding’s work (1981), which is not founded on the market failure/government failure analysis.

While it might be assumed that most “everybody” in the country enjoys at least a certain level of national defense production, not “everybody” enjoys or free rides from the services provided by Alcoholics Anonymous, MDA, the Sierra Club, or the Little Sisters of the Poor. While these services might display some public-good-like characteristics, the state cannot effectively, or, rather, efficiently, account for, and accordingly tax and fund, all the confoundedly diverse demands behind these and a panoply of other services. In Weisbrod’s view, free riders in the market will prohibit – if only unintentionally – the optimal production of these services. This typically leads to a call for government intervention to improve upon the outcomes of an otherwise spontaneous market process. But, Weisbrod argues, the government will also fail to generate specific taxes on specific people to ensure an optimal allocation – that is, to improve upon the market outcome. Hence, he maintains, nonprofits arise in response to *both* market and government failure. Nonprofits emerge as a “substitute” for state intervention in light of efficiency failures in the market place.⁵

Salamon (1987, p. 39; 1992, p. 125; Salamon and Anheier 1996, pp. 9-10) chides Weisbrod for failing to acknowledge a robust *partnership* between the nonprofits and the state, for viewing the two as substitutes rather than symbiotic complements. Salamon suggests that the real-existing partnership between nonprofits and the state is an anomaly from the perspective of standard theory, something that simply cannot be explained or predicted in traditional analytical constructs. Salamon offers the claim that the partnership is fundamentally a response to inefficiencies in the “voluntary,” nonprofit

⁵ In a recent paper Glaeser and Shleifer (1998) explore when entrepreneurs may decide to enter as a for-profit or not-for-profit entity. They argue that this decision relates to the incentives that potential entrepreneurs face, such that under certain conditions even a self-interested entrepreneur will opt to enter as a not-for-profit entity.

sector. “Given a welfare state that is characterized by an extensive pattern of third-party government,” he writes, “the persistence of a voluntary sector and widespread government –nonprofit cooperation are not anomalies at all: they are exactly what one would expect” (1987, p. 43).⁶

At the core, then, of Salamon’s self-described paradigm is the notion of efficiency, and its converse, inefficiency. To advance claims that a set of institutions – market, voluntary, or state – are failing is to make particular assumptions about the potential efficiency characteristics of those institutions. We shall therefore assess not only Salamon’s development and use of the “failure” concept; we shall also critically explore its use in standard economic analysis, from a Hayekian, process-oriented perspective. We suggest that not only is Salamon’s theory defective, but so, too, is the theory that critically influenced Salamon’s – that of standard economic analysis, including Weisbrod’s.

This paper will therefore raise, and try to answer, several questions: Precisely what does Salamon mean when he speaks of voluntary-sector failure – i.e., just how might nonprofits be inefficient, or how might they be judged “inherently limited”? What scientific basis has he provided which allows him to conclude that the merging or “partnership” between nonprofits and the welfare state are not only the *consequence* of

⁶ Salamon’s terms are confusing: aren’t market organizations voluntarily formed, and funded? So why distinguish between the “market sector” and the “voluntary sector”? What clarity does that add? In our view, the market sector would at least be seen as a subset of the voluntary sector. (At the same time, were one to use these terms, why not label the state sector as the “compulsory sector”?) For now we shall stick with Salamon’s terms: by “market sector,” he means the traditional for-profit marketplace; by “voluntary sector” he means the panoply of nonprofit organizations; and by “government sector” he indeed means the state’s legitimate monopoly of coercion. Finally, his term “third-party government” has nothing to do with political parties. It is his label for the institutional partnership between the federal government and other organizations, including nonprofits, one whereby the federal government “increasingly relies on a wide variety of “third parties” – states, cities, special districts, banks, hospitals, manufacturers, and others – to carry out its purposes” (Salamon 1981, p. 19).

voluntary sector failure, but also an efficient *improvement* within that sector? To be sure, Salamon recognizes that answers to these kinds of questions “is more conceptual than empirical” (1987, p. 35) – we can’t simply go off, willy nilly, and measure “the” results. We instead require some theoretical framework to give us clues as to *what* (and how) we should be measuring, and how the results are causally related to earlier institutional events and developments. In this sense Salamon’s metaphor of needing new theoretical “lenses” is most apt. But does Salamon’s new theory provide insight and clarity? Has he firmly established the notion of voluntary-sector failure, and the efficiency-enhancing role of the state among nonprofits? We already know Salamon’s ideological sentiments encourage a more robust linkage between nonprofits and the state, but has he developed a consistent, positive theory that provides the kind of apriori or conceptual framework – a paradigm, in his words – that matches his ideological hope with empirical possibility? We shall see that he doesn’t.

Again, our paper is much less interested in Salamon’s ideological vision. We shall assess his theory itself. And that requires us to discuss the standard economic analysis of “market failure.” What do economists mean when they say that a market “fails”? And what do they mean when they say that state intervention can potentially improve upon market failure? What, if anything, does government failure mean in this context? We shall begin by carefully discussing the theory of market (and government) failure, for Salamon’s theory cannot be understood without some exposure to the alleged efficiency (and inefficiency) characteristics of markets. Not only does Salamon adopt the same terms used by standard economists, but he also introduces his own notion of voluntary failure. Is he using these concepts consistently? Does he have clearly

specified benchmarks to justify his voluntary-sector failure theory, benchmarks which further support his case for government-nonprofit partnership? Moreover, what would a Hayekian analysis offer that is found in neither Salamon nor Weisbrod? We shall explore these questions in what follows.

From Market Exchange to Market Failure: The Public Goods Problem

So far we've used the terms "public goods," "market failure," "government failure" and so on rather freely, as if our readers already understand these terms. While this is standard parlance among economists, others often adopt these concepts loosely, and erroneously, for the terms have specific meanings. To understand the Salamon paradigm we need to be better acquainted with the standard economic paradigm he is reacting against.

So, imagine an idealized economy in which all participants enjoy several limiting assumptions, including: full and complete information; zero transaction costs; prices that they take as given (i.e., beyond any one individual's, or coalition of individuals', ability to manipulate). Standard economic analysis has established that individuals within this hypothetical economy will harbor the ability, and the incentive, to freely exchange their property – goods and services – until *all* mutually-beneficial exchanges have been exhausted. Once reached, any further exchange or redistribution of goods, though beneficial to one (or some) parties, will reduce the utility or well-being of other parties.⁷

⁷ This is the notion of Pareto Optimality. Generally, in the Pareto Optimal market outcome, all prices are equilibrium prices, which reflect equalities between the marginal rates of substitution in consumption and the marginal rates of substitution in technical transformation. That is to say, different demanders have the same marginal values for a specific good, and different producers have the same marginal cost of producing

The free market, under these severely limiting assumptions, is considered capable of generating a socially-optimal outcome. Although the term “efficiency” has varied meanings, in the theory of standard welfare economics, efficiency is synonymous with Pareto-Optimality – the complete exhaustion of all mutually-beneficial exchange possibilities.

In the economics literature there are formal proofs that under conditions of *general competitive equilibrium* the economic system will achieve simultaneously production efficiency (i.e., all least cost technologies will be employed), exchange efficiency (i.e., all mutually beneficial gains from exchange will be exhausted), and product-mix efficiency (i.e., individuals will receive the bundle of products they are willing to pay for). The Two Fundamental Welfare Theorems follow from these: (1) an economy in general competitive equilibrium is Pareto Efficient, and (2) any Pareto Efficient distribution of resources society desires can be achieved through the market mechanism. When economists speak of “market failure” it is against this standard of the first and second welfare theorem that we are referring.

Market failure, therefore, has a rather refined and specific meaning to economists. Market failure refers to cases when voluntary exchange fails to reach this *Pareto-Optimal* or “efficient” outcome. The production of a good that creates a negative externality, such

that good, and those marginal values and marginal costs are equal to the (given) equilibrium market price of that good. For example, if the equilibrium price of a loaf of bread were \$3.00, then consumers will purchase bread until they value the last (“marginal”) loaf at \$3.00, and bakers will produce up to the point that the last (“marginal”) loaf produced cost \$3.00. In this scenario, there is no longer room for mutually beneficial trade. Other things constant, any given consumer would value *one more* loaf of bread less than \$3.00; but any given baker could produce *one more* loaf of bread at a cost higher than \$3.00, so all bargaining possibilities have been fully exhausted.

as pollution, is a common example.⁸ The Weisbrod case for nonprofits focuses, however, on the potential for markets to generate *positive* externalities, and, more specifically, *public goods* problems.

Suppose the production of a good generates a positive externality. But not only that. Suppose the good is such that (1) my consumption of the good does not reduce the amount available for any other consumer (economists call this “non-rival consumption”) and (2) it is technically impossible to keep free riders from enjoying their free ride. In this case, we’ve hit the defining characteristics of a public good.⁹ National defense is a traditional textbook example. Tax-supported public education, though not a pure public good, also is said to have significant spillover benefits that are nonrival and nonexcludable – not the education itself, but the fruits of having better-educated people as neighbors and coworkers. In the former, my sense of security of a national defense program doesn’t reduce, in principle, the amount of defense available to others; once the defense service is produced, it is impossible to keep other citizens from also enjoying that sense of protection. In the latter example, others in society are said to gain by having

⁸ A negative externality or “spillover cost” occurs whenever a voluntary exchange between two parties negatively affects (reduces the utility, or well-being) of a third party not associated with the exchange. That party bears some of the cost of the others’ actions, without being compensated by a corresponding benefit. The outcome therefore fails to meet the Pareto-Optimal notion of efficiency: the traders gain, but others lose. In this sense, the market *overproduces* goods that generate negative externalities, because the trading parties fail to account for all the additional costs (the “social” marginal costs) of production. The counterpart to negative externality is, of course, positive externality, a kind of spillover benefit. Here, a third party enjoys a benefit of other traders’ actions, without paying. Your landscaped and well-maintained lawn is a benefit to me across the street, although I don’t pay a penny for the landscapers you hired. In principle, I, the free rider, would be willing to pay something to see your lawn in good shape, if not even nicer shape. With positive externalities, the market *underproduces*. More production would occur if free riders were to actually pay for the goods that they, too, enjoy. If they have no incentive to pay, potentially mutually-beneficial exchange opportunities remain unexploited. This outcome, too, therefore fails to reach the Pareto-Optimal (what we shall simply call “efficient”) level of output. A crucial part of all of this – known formally as the theory of welfare economics – is that *the concept of market failure makes sense only against the benchmark of the Pareto-Optimal, or fully efficient, ideal*. Pareto Optimality is the ideal against which standard economic theory evaluates market efficiency and market failure.

⁹ Is your well-maintained lawn a public good? Not if, for example, you can plant spruce trees at the front of your yard, erect a fence, etc to keep others from viewing your prized property.

children in school (from quieter neighborhoods in the daytime to smarter and more productive citizens), and it is impossible to keep them from enjoying those benefits.

The concern, then, is what incentive will participants in a free market have to produce an *efficient* – that is, Pareto-Optimal – level of output of a public good? Standard economic theory concludes that the incentive will be nil. This is not to say that *no* public goods will be produced in the free market; rather, it suggests that the level of output that is produced will necessarily fall short of the efficient level. Free riders, being impossible to exclude, will exist, and therefore the market fails to fully exhaust mutually-beneficial exchange opportunities. Even if it produces defense (through private militias) or education (through privately chartered schools) the market system will underproduce – it will fail to produce “enough” -- not in the sense of fairness, or justice, or what have you, but in the *refined* sense of the “optimal” or “socially efficient” outcome.¹⁰

Thus the concern with public goods, situated against the benchmark of the fully-efficient market ideal.

Rectifying Market Failure through State Intervention

The theory of the public goods problem contains a clear solution – that is, a clear theory of economic policy to rectify the problem and propel the market towards the efficient outcome. Indeed, the theory of the policy solution is, in a sense, as “simple” as the modeling of the situation that gives rise to the problem in the first place. For the sake of those untrained in economic analysis, we’ll continue to avoid a graphical illustration.

¹⁰ Salamon doesn’t seem to appreciate this point, which will become clear when we discuss his notion of “voluntary failure.”

The textbooks typically model the public goods problem with the simplifying assumption of only two demanders. (Once you understand the two-demander case, the n -demander case becomes apparent.) Suppose the public good is defense. Demander A, for whatever reason (ranging from his psychological state to the amount of property he owns) is willing to pay, say, \$3,000 per year for one “unit” of defense services, \$2,000 a year for a second “unit”, and \$1,000 per year for a third “unit” and nothing for a fourth “unit.” Demander B, for whatever reason, has different tastes. (People can, and do, have different tastes.) She’s willing to pay \$2,000 per year for one unit, \$1,000 per year for a second unit, and nothing for a third. Suppose also that the cost of producing any additional unit of defense service is \$3,000 per year, and that the for-profit provider of the service can, at best, charge the break-even price of \$3,000 per unit.

Now, it might turn out that both parties wait to see what the other party will do. That is, each hopes to free ride, and therefore nothing gets produced. Or, at the \$3,000 price, A decides to “subscribe” to 1 unit of defense service. His tastes dictate no further purchases. But once the unit is deployed in the area, not only does A benefit; B also enjoys the full benefit of a unit of defense service without having to pay. In the model, we – as economists and would-be policy devisers – *already know* not only A’s marginal benefit from the service (\$3,000). We also know B’s marginal benefit: it’s \$2,000. (How do we know that? It’s already built into our assumptions. A values 1 unit at \$3,000, and B values it at \$2,000.) How can we conclude that the free market “underproduces” the public good? Well, *taken together*, the “social marginal benefit” to the demanders is \$5,000. Yet, the cost of producing the defense service is only \$3,000. The for-profit firm collects only \$3,000 from A, and acts accordingly; having no power to

“tax” demander B (or any other demanders in the *n-person* case), it voluntarily produces only 1 unit of defense service. Because both “demanders” value the good more than its additional cost of production, there’s room for further beneficial trade to *all* parties – A, B, and the firm itself. The firm could profitably expand its output, with *no* harm to A or B. B’s free riding prohibits – if only unintentionally – this outcome.

What, then, is the “optimal” level of output that this market fails to hit? Graphical analysis would clearly show that it’s 2 units. Recall that A values a second unit at \$2,000. B values a second unit at \$1,000. Taken together, the “social marginal value” is therefore \$3,000, and that is *exactly* the marginal cost of producing a third unit of defense service.

What to do? The standard policy solution is already at hand. *Because we have all the necessary information at our disposal*, we could propose that the state steps in and taxes both A and B. A is forced to pay a tax of \$2,000 per unit (that’s his marginal value placed on the second – and in this case optimal – unit of defense service) and B is forced to pay of tax of \$1,000 per unit (that’s her marginal value placed on the second unit of defense service). Nobody free rides; everybody pays not their “fair share” per se or the “just price,” or what have you, but rather a tax that reflects the additional value they place on the optimal level of output. Those taxes go – in our example – to subsidize the for-profit defense firm. A pays a total of \$4,000 and B pays a total of \$2,000, which adds up to \$6,000 revenues for the firm. With \$6,000 the firm would produce 2 units of service.

In this simple scenario, while the market failed, state intervention propelled the market to its optimal, or socially-efficient outcome. This all appears fairly straightforward in the 2-person case. Actually, however, so-called public goods are

rarely if ever a problem for markets in small-number cases. Social pressure might be enough to encourage B to give up the urge to free ride. In *n-person* cases (where *n* is stylistically large, such as 5,000 or 5,000,000) an individual enjoys greater anonymity, and the concern for the market provision of public goods is greater.

At the same time, the pure theory, and its policy solution, becomes outright untenable. If our readers had even a little difficulty with our two-person example, think of several thousand if not millions of potential “demanders” of a public good. How in the real world would policy makers – even making the unrealistically heroic assumption that they are exclusively concerned not merely with the “public interest,” but in particular with maximizing economic efficiency and generating an “optimal” outcome – come to know what each individual would be willing to pay for any particular level of output? How would they unearth that information in a world where free-riding is a possibility? Moreover, just what does it mean to be a “demander” for a good when the individual voluntarily refrains from spending her money on that good in favor of other goods and services? How, in other words, could we possibly expect policy makers to determine what the “optimal” level of output is – in the real world – and tax all beneficiaries according to their own individual values? These are thoroughly Hayekian questions, to which we shall return. For now, suffice it to say that “market failure” means a failure of the voluntary exchange process to hit a purely hypothetical optimum, therefore “government failure” – to be consistent – means a failure of the state’s powers to compel its citizens to also hit the purely hypothetical optimum.

Weisbrod’s work uses the market failure concept correctly. It seems to us that he uses the concept of government failure in roughly the same way. He suggests, however,

that the problem lies with appropriately taxing highly diversified demands across heterogeneous public goods:

Dealing with diversity – which is fundamentally a problem of information – is a major problem for government. If all consumers had identical demands for public action – whether for trust-type, consumer-protection services, or for other collective goods – this problem would disappear. When demand is diverse, though, whatever quantities and qualities of services government provides will oversatisfy some people and undersatisfy others. Can the nonprofit form of institution respond? (1988, p. 25).

Claiming that the calculation and taxation problem would “disappear” with relatively consistent demand is a ridiculous and unusually strong statement -- even for an economist! The Hayekian point we wish to advance is that we – citizens, economists, policy makers – cannot possibly know people’s unexpressed “demands” in real-existing economies, *regardless* of whether or not we have apriori beliefs that those demands might be homogeneous for some goods and heterogeneous for others.¹¹ We have here the all-too-common instance of misplaced concreteness, a confusion of the model with reality. When the model doesn’t mirror reality (and trust us, we don’t harbor ideas that models should mirror reality!), welfare economists tend to conclude that *reality fails*.¹²

¹¹ See Hayek’s “Economics and Knowledge,” and “The Use of Knowledge in Society,” in Hayek (1948, pp. 33-56 and 77-91) for a general discussion of the assumptions of our knowledge in economic theory. On the particular issue of positive externalities and public goods, see Heyne, Boettke, and Prychitko (2003, pp. 323-43) and Wagner (1996).

¹² This is one among many examples in economic theory. See Machlup (1958).

Weisbrod suggests nonprofits can mitigate government failure. Alas, however, he doesn't demonstrate that nonprofits generate the optimal outcome in light of government failure, *nor* that nonprofits come "closer" to the optimal outcome. In fact, he *cannot* demonstrate that real world nonprofits do either. He, nor any other economist, knows what the Pareto Optimal point is for *any* aspect of society. This is not an argument against nonprofits. Instead, it is an argument that questions the value, and purpose, of the Pareto-Optimality benchmark that undergirds the market failure/government failure analysis.

On the Notion of Voluntary Failure

Salamon's new paradigm is critical of the market failure/government failure explanation of nonprofits, too, but for fundamentally different reasons. He seeks not to question standard welfare theory. Indeed, we haven't come across *any* mention of Pareto Optimality in his writing.¹³ His objection, it appears, is over the implications of the data. His reading of Weisbrod suggests, to him, that the standard theory cannot account for the *empirical* interconnections between the welfare state and nonprofit organizations, that is, for the *fact* that nonprofits are often involved in the direct *delivery* of services, being supported through compulsory state actions through subsidies and other measures. Salamon claims this "partnership" remains a factual anomaly in the Weisbrod model. But "not only does this partnership have deep historical roots," Salamon maintains, "it also has a strong theoretical rationale" (1989, p. 204). He goes so far as to say that this

¹³ To be sure, he does occasionally use the term "optimal," as in "So long as sole reliance is placed on a system of voluntary contributions, . . . , it is likely that the resources made available will be less than those society considers optimal" (1987, p. 45). Elsewhere he talks about the voluntary sector's "limited... ability to generate an adequate level of resources" (1987, p. 48). It is completely unclear precisely what "optimal" or "adequate" mean in his new paradigm.

“partnership” had been a “central organizing principle of the American welfare state” (1989, p. 205).¹⁴

Salamon believes his paradigm provides the theoretical rationale. His case rests upon his concept of “voluntary failure.” This concept, however, is drawn from a misunderstanding of the standard theory of government intervention when trying to improve upon so-called market failures, and, therefore, a misinterpretation of the otherwise anomalous facts.

Salamon misunderstands the objective of government intervention in light of positive externalities and public goods. He claims that

The central problem with the theory of the welfare state as it has been applied to the American context is its failure to differentiate between government’s role as a provider of funds and direction, and government’s role as a deliverer of services....

Far from the bureaucratic monolith pictured in conventional theories, the welfare state in the American context makes use of a wide variety of third parties to carry out governmental functions. The result is an elaborate system of “third-party government”... in which government shares a substantial degree of its discretion over the spending of public funds and the exercise of public authority with third-party implementers (1987, p. 41).

¹⁴ Which, he regrets, since the Reagan years had begun to lose its coveted place as the central organizing principle. See Salamon (1989, 1993). At the same time, he has hope for other forms of nonprofit-state collaboration, as in the German corporatist model and the proposals set forth in the U.K. Home Office Scrutiny Report (Salamon and Anheier 1996b, pp. 121-22).

Salamon conflates the case for government *taxation and funding* of goods associate with positive externalities and public-good characteristics with government *production* of those goods. That is, he observes a world where these two functions are often separate – and labels that phenomenon “third-party government” – and also claims that standard welfare economics *cannot conceptually explain* this separation. (Hence the “anomaly” he sets out to explain in his new theory.) Unfortunately Salamon shares a common but erroneous belief that the standard economist’s case *necessarily* involves a combination of government funding and production, but that just isn’t so. James Buchanan stated it clearly in one of the early, landmark works on the subject:

Collectivization, or public organization, refers to the provision of the good, its financing and distribution among separate demanders. Nothing in the discussion implies anything at all about the actual *organization of production*. Whether or not the good is purchased from privately organized firms and individuals in the domestic economy, purchased from privately or publicly organized supplying agencies abroad, or produced directly by government itself should depend on an efficiency calculus which compares these various alternatives. Collectivization of the supply, to meet individuals’ private demands, says nothing about the relative efficiency of producing the good in any one of the several ways. This is a self-evident point, and it would not be necessary to mention here were it not for the widespread confusion that seems to exist (1968, p. 186).¹⁵

¹⁵ Buchanan’s point became conventional textbook material on the theory of public goods, long available before Salamon embarked upon a new paradigm. Thus Jack Hirshleifer (1980, p. 542) writes:

Salamon's hope to now explain "third-party government" with a new paradigm – one that can finally begin to account for this "anomaly" (in other places, "aberration" [1995, p. 6]) – is without legs. Simply stated, there is no anomaly at all, for nothing in standard economic analysis suggests, as a general principle, that government intervention used to correct for market failures necessitates government *production* of those "failed" goods and services. Rather, standard analysis typically suggests that the government can improve the efficiency of the market by forcing free riders to pay for the goods that they enjoy – that is, by taxing them. The specific organization of production – determining property-rights arrangements as to who will produce and supply the good or service in question, is an altogether separate matter, one that, in the standard analysis, rests with the relative costs and technical efficiencies of the private sector as compared to the public sector. Salamon's conflation of the two is an unfortunate misunderstanding of basic economic theory.

Now, that in itself neither requires nor allows us to reject his concept of "voluntary failure." The standard "paradigm" has already accounted for and explained non-government production of public and other goods with significant positive externalities. Its theoretical "lenses," as it were, have already observed what Salamon otherwise considers unobservable. Perhaps, on the other hand, his "voluntary failure"

According to some welfare theorists, the various difficulties in private supply of public goods dictate that they be "publicly" (i.e., governmentally) provided instead. Indeed, some have thought that the concept of public goods serves to define the proper scope of government: "Private goods" ought to be privately supplied, and "public goods" ought to be publicly supplied. But in fact we do observe private firms supplying public goods. Television broadcasting is the obvious example, but even lighthouse services have at times been privately provided. And on the other hand government agencies, while supplying public goods like national defense, are also in the business of producing a vast range of private goods. Among the many examples are electric power (TVA), irrigation water (the U.S. Bureau of Reclamation), insurance (Social Security), education (public schools), and of course postal services (the U.S. Mail).

concept can be fitted *into* the standard analysis, and thereby provide greater clarity – and, with that, the normative defense of government-nonprofit collaboration that Salamon hopes to (and has tried to) develop over the years.

As mentioned above, Salamon advances claims that the voluntary sector is “inherently” limited; it will likely offer services that “will be less than those society considers optimal”; it “has serious drawbacks as a generator of a reliable stream of resources to respond adequately to community needs.” He at least *implicitly* accepts the Paretian benchmark when he acknowledges the possibility of both market and government failure. To be consistent, then, he must accept that same benchmark to meaningfully speak of the “voluntary failure” to general an “adequate” and “optimal” level of nonprofit services. Otherwise, what else do these terms mean? To suggest that government-nonprofit collaboration *improves upon* the voluntary sector’s outcomes, that it *overcomes* its inherent limitations, requires some kind of benchmark that is consistent with the other two failure concepts. But Salamon develops nothing of the kind, in his 1987 paper or after.

Note that we do not advocate that Salamon do this. We think the entire welfare economics framework is flawed with unrealistic assumptions, and unrealizable goals and expectations for policy makers and government bureaucrats. It is an exemplar of misplaced concreteness, but at least it has the “virtue” of clearly articulating – at the purely conceptual, theoretical level – what optimality and failure mean.

Salamon accepts in principle the notion of market failure and social optimality. He advances claims that “third-party government” can propel the for-profit and nonprofit sectors toward a socially optimal outcome. He, however, has not clearly articulated what

he means by these concepts. *If* he has the Pareto-Optimal criteria in mind, he hasn't made any effort to demonstrate that the modern welfare state's funding of nonprofit services has propelled the system closer toward the socially optimal outcome *nor* that the wonderfully robust panoply of nonprofits, being disentangled from the state (a more recent development he laments), has pulled the system further away from the socially optimal result. If, on the other hand, he *doesn't* accept the Pareto-Optimal criteria, then why does he continue to acknowledge the standard notion of "market failure," and why hasn't he bothered to articulate – if only at the conceptual level – what he means when developing his own optimality criteria?

Salamon is indeed correct that the "real answer" to the questions that he seeks to address in his body of research is "more conceptual than empirical." But his own theory offers a set of unpolished lenses, which seem to distract more than clarify.

Governance and the Nonprofit Sector

We hope to have shown that Salamon does not offer a coherent theory – let alone a new paradigm – to explain, and defend, the nonprofit-government partnership. Our contribution, therefore, is one of a critique of an established position in the literature of the nonprofit and philanthropic sector of society. Space limitations preclude us from offering a full-blown alternative theory of the function of the so-called voluntary sector ourselves – one that is a useful alternative to that of both Salamon and Weisbrod. At the same time, however, we've shown that there's indeed a need for such a theory.

The theoretical alternative to Salamon's "third party government", we suggest, would build on the distinction between the financing and provision of so-called public

goods that Salamon's considers so anomalous to standard economics. As we argued above, it is not anomalous in the least, and the distinction is in fact crucial to keep in mind. James Buchanan (1975) has distinguished in his work between the protective state (national defense, courts, and police), the productive state (provision of public goods such as roads and bridges), and the redistributive state (interest group politics, rent-seeking, and welfare policies). In the Buchanan constitutional political economy project, the task is to at one and the same time empower the protective and productive state yet constrain the redistributive state through constitutional construction. The problem, of course, is whether such a balancing act can indeed be accomplished once the power to tax is established. Unless there are strong constraints on the expansion of state power, the natural proclivity of the state would be to use its power of tax to benefit some at the expense of others.

In a free society, the voluntary sector plays a crucial role in reinforcing the constitutional constraints to make sure that government is limited to those activities, and only those activities, which it has a reasonable claim to engage and use its coercive power of taxation and monopoly provision. Now that is not the primary purpose or goal of nonprofit and philanthropic enterprise. Voluntary-sector associations are organized to serve particular human needs. Rarely – if ever – do the agents of such associations have in mind the objective of limiting the compulsory powers of the state. But that's precisely what makes this function so elusive. A robust, interconnected system of nonprofits and other civil-society associations-- as an unintended consequence – function to reinforce constitutional constraints on the state. And it's this unintended, though systematic

feature, of the voluntary sector that is ignored by standard analysis, and by Salamon's approach.

Many people misunderstand the argument made by economists such as Buchanan or Friedman or Hayek concerning the role of government. Their concern is less with the scale of government than the scope. Of course, the absolute size of government can be a concern given fiscal realities. But the primary concern is the activities government attempts to tackle. There are those activities which government should not be involved with in a free society. In the United States, for example, the general population would object strongly if government attempted to take over the financing and production of religion and perhaps even news services, but they don't object to government financing and provision of educational services. It is not our purpose here to debate these issues, but simply to argue that Salamon's lack of conceptual clarity leads him to err in explaining the functional significance of the voluntary sector in a society of free and responsible individuals. The voluntary sector ceases to serve this function when organizations within it partner with the coercive powers of the state. It is at that juncture that neither government nor market shortcomings can be overcome by this "third sector" because, instead, nonprofit organizations are transformed into rent-seeking entities which are dependent on tax-finance rather than the voluntary contributions of individual donors. Certainly these organizations provide goods and services, but are the necessary feedback and disciplinary mechanisms in operation to ensure that good intentions are channeled in a direction which generates desired results?

Hayek's work forces readers to consider the capacity of learning within alternative institutional settings. Essential to the learning process is blunt and continual

feedback to actors so they may become informed about the effectiveness of previous actions. It is precisely because in social interactions human intentions do not automatically equal the realized results that a results-orientation must trump considerations of intentions and moral intuition in economic analysis. Actors must be disciplined to align their behavior with desired outcomes, and they must be continually informed about how best to align their behavior. In a for-profit setting actors receive signals through the price system that aligns their incentives appropriately. In the political setting of democratic politics, political actors are disciplined in theory through the vote mechanism. In the nonprofit sector, actors must rely on the signal of voluntary contributions and construct measures of output to show that desired results are in fact being achieved. This is an admittedly difficult project, not only for the real-world participants within this sector, but also for theorists who strive to explain the coordinating properties of the sector.¹⁶

Politics also does not work as smoothly as theory might predict. The vote mechanism is not as effective at disciplining politicians because of various public choice problems. Markets, while undoubtedly very effective at disciplining actors, cannot be relied upon to price many products that are nevertheless essential to creating a vibrant and just community. Thus, it is important to delineate the appropriate role of government and look at the functional significance of nonprofits in filling in the gap left by government and the market. But again, this voluntary sector can only serve this role if it is denied access to the power of tax.

Hayek (1979), building on the work of Richard Cornuelle (1965), argues that the voluntary sector has great potential for ensuring social cooperation by mobilizing

¹⁶ See Boettke and Rathbone (2002) for a discussion of the difficulties facing the philanthropic enterprise.

individuals to work to improve community environment, health, education, work opportunities, and even the basic codes of conduct we rely on in our daily intercourse. Ironically, Cornuelle contends, as the voluntary sector gained the power to accomplish more things due to technological innovations in the 20th century, ideological shifts led to a situation where more of these activities were turned over to the government rather than the voluntary sector. Hayek suggests that in order to buck this trend we need to insist on restrictions on the scope of government activities and to separate not only finance and provision of those services done by the government but also to challenge the monopoly of provision.¹⁷ It may indeed be the case that certain goods and services cannot effectively be provided by the market (given the current technological stage of development), but this should not be seen as a justification either for coupling finance and provision, let alone monopoly status in provision. In particular, Hayek warns that claims to monopoly provision by the state are made not in order that citizens will be better served, but instead to enhance the powers of the government (see 1979, p. 56). As such even when it has been established that the government should finance and produce a particular good or service, the claim to be a monopoly provider must be denied. The most harmful abuse that consumers face in their everyday life is not enduring high prices, but “the political coercion to make uneconomic use of resources” (1979, p. 59).

¹⁷ As he argues at one point, emphasizing the scale/scope issue, “In recent times it has been seriously maintained that the existing political institutions lead to an insufficient provision for the public sector. It is probably true that some of those services which the government ought to render are provided inadequately. But this does not mean that the aggregate of government expenditure is too small. It may well be true that having assumed too many tasks, government is neglecting some of the most important ones” (1979, p. 53). Hayek does argue that we should worry about the scale of government, but the issue of scope may indeed be the more important. Government must be restricted to those tasks that it can accomplish with reasonable effectiveness and strictly prohibited from engaging in those activities which it cannot accomplish in an efficient manner. The clarity of this delineation is clouded by the coercive power to levy taxes and to establish a monopoly in provision of the good or service under consideration.

Competition, whether in the for-profit market setting or amongst nonprofit entities attempting to meet the needs of particular populations, ensures that actors will constantly be under pressure to respond more effectively in the production and distribution of the products under consideration. None of these processes will hit a hypothetical Pareto-Optimal outcome. Rather than compare markets, the nonprofit sector, and the state against an unattainable benchmark, however, we suggest that a positive theory ought to adopt a comparative-institutions analysis, one which addresses the dissemination of knowledge among participants as well as their incentives to act on that knowledge in ways to further coordinates their plans. We suggest, with Hayek, that monopoly privilege and the coercive power to tax to finance one's activities thwart the learning process and lead to ineffective use of resources and the inability to effectively meet the demands of the target population, *compared against* the free market and the independent voluntary sector. Those who advocate a partnership between business and government on the one hand, and the voluntary sector and government on the other, as well as government taking on more and more responsibilities in our economic life, fail to recognize "that every step made in this direction means a transformation of more and more of the spontaneous order to [sic] society that serves the varying needs of the individuals, into an organization which can serve only a particular set of ends determined by the majority --- or increasingly, since this organization is becoming far too complex to be understood by the voters, by the bureaucracy in whose hands the administration of those means is placed" (1979, p. 53).

We suggest, then, that the sort of "third party government" advocated by Salamon would distort the incentives for innovation, for filling in the gap left by for-profit firms

and traditional government bureaucracies. It would not invigorate the voluntary sector. His lack of conceptual clarity has led Salamon into an error in analysis about how the voluntary sector can most effectively meet the demands of its constituency.

Conclusion

Confusion in the social sciences are often the result of ambiguity introduced by one of two sources --- (1) using the same words to mean different things, or (2) using different words to mean the same thing. The use of terms such as “optimality”, “market failure”, “government failure” and “efficiency” have particular technical uses. The case for government as a corrective mechanism to so-called market failures is built upon demonstrating the sub-optimality of market mechanisms in allocating resources. But market processes do not, and cannot, do everything, let alone reach Pareto-Optimality; nor can political processes.

We have argued that Lester Salamon invokes the language of market failure economics, but lacks the argument to back his case. Instead, we are introduced to a misuse of economic terminology to make an argument for “third party government” which, if pursued as a policy objective, would generate results the opposite of what Salamon himself would hope from his idea. Rather than generating a responsive independent sector which would meet the social demands of its constituent populations, the partnership of government and the voluntary sector would result in an unresponsive bureaucracy which pursued activities that might appeal to our moral intuitions but do not address the actual consequences of its activities.

If the voluntary sector is going to serve its vital function in a free society, then we must move beyond platitudes about intentions to do good, and insist on measurements which demonstrate that the desired outcomes are indeed being achieved. The focus must shift from looking at intentions to actual, unintended consequences and measured output. This requires a fundamental shift in attitude which cannot occur inside a government partnership. We have argued that a responsive voluntary sector must instead be independent of government. The coercive power of taxation and monopoly privilege must be eschewed in favor of the powers of voluntary collaboration and exchange of property rights, the pressures of competition, and the continual feedback which prods innovation and the discovery of better ways to serve the needs of the population.

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